TREASURIES AND CENTRAL BANKS

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ESPECIALLY IN ENGLAND AND THE UNITED STATES

By

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TO

THE MEMORY

OF

A. L. SMITH

AND

H. W. C. DAVIS

AUTHOR'S PREFACE

THIS book was written as a doctoral dissertation at Columbia University during my tenure of a Commonwealth Fund Fellowship. I wish to express my gratitude to the Commonwealth Fund for giving me this opportunity and for much kindness during my stay in the United States.

Professor H. Parker Willis supervised my work, and I am deeply indebted to him for his generous and unfailing encouragement and guidance at every stage. Professors R. M. Haig, J. W. Angell and B. H. Beckhart read the manuscript and made helpful suggestions for which I thank them.

My thanks are also due to Sir Basil Blackett and Mr. R. G. Hawtrey for kindly discussing some points with me, and to the former particularly for his kindness in writing a Foreword.

The original intention was to include a detailed study of the experience of some other countries, especially France and Germany. This has not been possible at present, but I hope I may be able to cover this ground in a later work.

DAVID W. DODWELL.

LONDON,
August, 1934.

FOREWORD

By Sir Basil P. Blackett, K.C.B., K.C.S.I.

Mr. Dodwell has made good use of the opportunity given to him when he was awarded a Commonwealth Fund Fellowship. I am very glad to accede to his request that I should write a Foreword to his book on Treasuries and Central Banks, in which he has brought together the fruits of his special research.

In the complicated world of modern finance the relations between the Treasury and the Central Bank of a country and between them and the money market are of vital importance. Expert management of the Government's banking accounts is essential if the delicate machinery of finance is to work smoothly, and the control of credit cannot be handled without wasteful friction if the Treasury and the banking system are not in close and constant touch. For reasons which Mr. Dodwell's book brings out clearly, the modern tendency is to secure this close connection through the medium of a Central Bank.

There can be little doubt that the old system of an independent Treasury is not suited to modern conditions. The story of its breakdown in the United States of America is well told by Mr. Dodwell. The parallel story of its gradual supersession in India, which is outside the scope of this book, is not less instructive. An understanding of the innumerable questions both of detail and of principle which arise in the practical business of managing a Government's receipts and payments is a useful corrective to the wilder notions which continually prevail as to the possible benefits of what is called the Nationalisation of Banking.

The twentieth century has seen a great expansion in the number and in the activities of Central Banks. The Art and Science of Central Banking had scarcely begun to be seriously studied before the financial crisis in America in 1907 and the long discussions which preceded the establishment of the Federal Reserve system in 1914. The present state of knowledge and practice has perhaps not yet brought the principles of Central Banking to finality. Stress has been rightly laid on the absolute necessity for the independence of Central Banks. In an imperfect world special safeguards are needed to secure that party politics and sectional interests shall not enter into the business of controlling the nation's credit machinery. In performing this function the Central Bank must further be free to consider the general economic and financial interests of the nation and not be hampered by demands from the Treasury for policies dictated by the immediate exigencies of the Government's own expenditure programme.

On the other hand, in an imperfect world there must always be suspicion lest Finance (with a big F) is exercising too dominant an influence to the detriment of Industry and Commerce, and the powers over the nation's life entrusted to the Central Bank are so great that it must always be amenable to the wishes of the community constitutionally expressed through the Government.

Mr. Dodwell's picture of the relations between the Treasury and the Federal Reserve system in the United States and between the British Treasury and the Bank of England is of particular interest. The process now apparent in the United States of an increased subordination of the Federal Reserve system to the Treasury is of great significance. In this country when sterling was on the Gold Standard it was comparatively easy to leave the Bank of England full freedom to carry out its statutory duty to keep the pound at par with gold. Inevitably, as in the case of the Exchange Equalisation Fund, active intervention by the Treasury in matters of Exchange control

is more frequent when the pound is off Gold and Exchange policy has not been defined by Statute.

Mr. Dodwell has spent much useful time in researches into British War Finance and the relations between the Treasury and the Bank of England during and since the War. As one who had some part in the business, I am struck by the obvious insufficiency, for Mr. Dodwell's purposes, of the available published material regarding the period 1914 to 1925. It is evident that the accounts given by the authorities whose works he has consulted are in most cases, at best, intelligent guesses as to the facts. An authoritative history of the War Finance of Great Britain is much to be desired.

The key to the whole story is without doubt to be sought in the very close day to day collaboration between the Treasury and the Bank. Even with the help of the Treasury files of the period, it would probably be impossible to disentangle the parts played by the Chancellor of the Exchequer and his officials on the one hand and the Governor and the Deputy Governor and Court of Directors of the Bank on the other.

If it is true that the independence of the Central Bank has been and is greater in Great Britain than in the United States, and if the relations between the authorities at the Treasury and those of the Central Bank have been more harmonious in this country than on the other side of the Atlantic, the explanation is probably to be found partly in personalities but mainly in the fact that Washington is over 200 miles from New York while Whitehall is under twenty minutes from Threadneedle Street.

Geography and past history count for much, and the conclusion may well be that the solution of the problem of the ideal relations between the Government and the Central Bank can never be determined by first principles, but must always differ from one nation to another.

Original research, such as Mr. Dodwell has carried out, is a most valuable contribution to the subject. Mr. Dodwell has found it necessary, for the sake of completeness, to confine his book to two countries, England and

the United States of America. There are other countries, particularly France and Canada, as well as India already mentioned, which would repay similar detailed study.

It is to be hoped that Mr. Dodwell, if he is not too busy applying his knowledge to practical purposes in India, will find time to extend the scope of his research. In any case his book should stimulate others to useful studies.

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CHAPTER I

INTRODUCTION

In the "good old days" every Government, like most sensible people, took it for granted that cash was safest in one's own pocket. The Government's pocket was represented by a well-guarded Treasury with its heavily barred doors and locked chests. But since reliable banks have come into existence, most Governments have sooner or later found it convenient to entrust to them, at least to some extent, the custody of their cash balances and the duty of receiving and paying out public money. A still more useful service which Governments have never been slow to appreciate and demand from banks is that of advancing money. In fact, banks have not infrequently been founded for the main purpose of enabling a Government to borrow funds more conveniently than would otherwise be possible.

Naturally a Government will usually carry its account with the "leading" bank of the country. Under modern conditions this means as a rule that it banks with the "Central Bank." Such a bank is different in kind from the ordinary commercial banks, since it has the special function of controlling currency and credit for the general good. The fundamental question then arises how far the Treasury, representing the Government on the financial side, should have any power to control the Central Bank in regard to this special work which is of such immense public importance.

The relations of a Treasury and a Central Bank may thus be classified under three main heads, as concerning:

(1) Public deposits and the Government's current banking accounts;

(2) Government borrowing and the management of the National Debt; and

(3) The general control of currency and credit.

In a country with a fully developed banking system there are clearly three possible methods of handling a Government's cash balances and current transactions: it may be done by the Government itself through an Independent Treasury system, or by the commercial banks, or by the Central Bank. The Independent Treasury system is generally condemned because it means a periodical withdrawal and locking up of funds which ought to be available for use in finance and industry. Of course a Treasury might lend out its surplus funds, but it may well be deemed unlikely that it could perform such money-market functions with as much efficiency and safety as could be expected from a reliable bank. Strangely enough, a recent writer has advocated this old-fashioned system of an Independent Treasury, partly on the ground that it is improper for any kind of bank to have the control and use of public funds, and partly on the ground that it is not safe for a bank to act as banker to a Government, since "every State Bank or Central Bank that has perished in history has perished because the State has taken its assets and given in return only a worthless I.O.U." [1]

The more usual, perhaps one may say the orthodox, view to-day is that it is extremely desirable both for the Government and the Central Bank that the latter should be made the Government's fiscal agent for all current transactions and also for the arrangement of its borrowing. To illustrate this, it may be enough to quote Mr. Montagu Norman, who has been Governor of the Bank of England since shortly after the end of the Great War and is generally recognised as the most eminent practitioner of the art of central banking. In defining the duties of a Central Bank he states as a matter of course that "it should be the holder of all the Government balances . . .

[1] W. Shaw, "The Theory and Principles of Central Banking," p. 225. See also pp. 227 and 242.

(and) should be the agent . . . through which the financial operations at home and abroad of the Government would be performed." This seems so self-evident to him as not to require any qualification or statement of reasons or argument. Moreover, he clearly regards it as of the very first importance, for he states that there are some principles for which he would fight more arduously than for others if he were starting a Central Bank and of these the one he mentions first is "the custody of Government balances." [1]

Mr. Norman was no doubt influenced a good deal, in forming the above opinion, by conditions in England, where the Bank of England has found the Government balances very profitable, and has been strong enough, for more than a century, to prevent any serious danger to its own position from being forced to make direct advances to the Government. As Kisch and Elkin point out:

> "The custody of the Government deposits is an important factor, as giving the Central Bank control, ordinarily free of interest, of large sums of money which, like the deposits of the joint stock banks, form part of the working assets of the Bank." [2]

Another writer is of the opinion that

> "as a general rule the business of keeping the Government's account is handed over to the Central Bank, often a purely *ad hoc* institution, with the object of giving it an earning power it might not otherwise possess and of endowing it with valuable prestige at the outset of its career." [3]

It is not always profitable, however, to hold a Government's banking account. Governments tend to be rather difficult customers, expecting a great deal in the way of services, which may sometimes be difficult and unusual, and not always being very willing to make an adequate financial return! If the Government is given overdraft facilities, it may quite well run its account on a

[1] Royal Commission on Indian Currency and Finance, 1926, Vol. V, Q. 14,571 and 14,980–1 (pp. 233 and 259).

[2] Kisch and Elkin, "Central Banks," 1928, p. 100.

[3] *Midland Bank Monthly Review*, London, March–April 1927, pp. 1–2.

zero or debit balance on the average, as seems to have happened in Holland. The high total deposits of the Netherlands Bank in the period 1875–1895 were due, it is said, to large Government deposits.

> " But after provisions had been made in the Bank Act obliging the Bank to grant advances on current account to the State, the importance of the Government deposits rapidly declined. During the last twenty years these have been so few and far between that they may be considered almost negligible." [1]

According to Mr. Hawtrey, the real reason why a Government generally wants to keep its account at the Central Bank is that it wishes to be sure of being able to borrow whenever it is short of cash.[2] Evidently a Government is perfectly justified in expecting its bank to give temporary advances to tide it over a time of year when, on account of seasonal fluctuations, expenditure exceeds revenue, whilst experience shows that in due course the flow will be reversed, and the Government's balances will be restored to their normal size. The difficulty is that a Government which finds overdraft facilities convenient for this legitimate purpose may be too easily tempted to use them more and more as a substitute for unpopular ways of raising funds. At a time of pressure it seems easy to cover a permanent deficit by borrowing from the Central Bank, but this may continue until irreparable harm has been done to the credit both of the Government and of the banking system. At any rate, much more drastic measures may be required to restore healthy conditions than would have been sufficient at an earlier stage. To minimise these dangers Central Bank constitutions sometimes impose rigid limits on the permissible extent of lending to the Government. Experience shows that such restrictions will almost certainly be set aside in any great emergency. When making a desperate attempt to avert some supreme national disaster, no Government would hesitate to issue its own paper money,

[1] Willis and Beckhart, " Foreign Banking Systems," p. 739.
[2] R. G. Hawtrey, " The Art of Central Banking," p. 266.

and, if necessary, take over the Central Bank. The wise and patriotic course for a Central Bank under such circumstances can only be to support the Government and carry out all measures which it dictates, whilst giving such advice as may tend to minimise the ultimate damage to the financial and banking structure. But restrictions on the Central Bank's lending to the Government are not necessarily useless because they will be ineffective in a crisis. It is something if they are effective in ordinary times. Perhaps a fairly strong case could be made out from this point of view for the fullest possible degree of independence for the Central Bank; to prevent it, as far as possible, from having any relations with the Government might seem the best way of ensuring that nothing but a real emergency would enable the Government to finance itself through the Central Bank. The League of Nations was much influenced by this desire for the independence of the Central Bank when it took part in the drafting of Central Bank constitutions for several European countries in the post-war decade.

The essential task of a modern Central Bank is undoubtedly the general control of currency and credit with a view to the smooth working of the money market and the banking and financial mechanism; it acts as a regulator of the whole money and credit structure. We cannot therefore be wrong in asserting that its connection with Government deposits and Government borrowing ought to be that which will most facilitate the performance of this primary function.

Usually it is held that the Central Bank should conduct the Government's financial business, because then alone will it be in a position by special operations to prevent fluctuations in the size of the Government balances from having injurious effects on the general money market. Obviously a large excess of payments over receipts by a Government in cash at an Independent Treasury would tend to produce ease in the money market, whilst large net receipts by the Government in cash would similarly lead to stringency. When the receipts and payments

are in Central Bank funds, the same principles hold good, since Central Bank funds are included in the cash resources of the other banks. If Government balances at the Central Bank are suddenly reduced by large payments to the public, the recipients will deposit these funds in the commercial banks, which consequently find their reserves increased to that extent. The banks then in normal times, since their reserve ratio is more or less fixed by law or custom, will expand their loans and investments; in any case, more funds will be available for the time being for short-term lending, and there is a temporary easiness of money. Similarly, large net payments by the public to the Government which are deposited in an account at the Central Bank must reduce the funds available to the money market, and so produce a temporary stringency.

These effects on the money market can, however, be offset by suitable "open-market operations" on the part of the Central Bank. The most important Central Banks have developed an effective technique in this connection, and it is generally admitted that they do at least greatly mitigate in practice the injurious disturbances that would otherwise be caused to the money market by these fluctuations. Thus a recent writer on the Federal Reserve System states that

> "those fluctuations in the supply of or demand for funds which are due to Treasury operations . . . can be compensated by transactions which put just enough credit into the market, or take enough out of the market, to offset the temporary disturbing influence,"

and he considers that "the Reserve system has been very successful in ironing out disturbances which originate in Treasury operations." [1] Similarly, for England, we are told:

> "It is well known that by its open market operations the Bank is able to maintain relatively stable conditions when carrying out

[1] C. O. Hardy, "The Credit Policy of the Federal Reserve System," pp. 65, 68.

large money operations connected with Government and international finance, and to mitigate the disturbances that would otherwise be caused by large transfers of funds between the State and the taxpayer, and by other factors of a similar type." [1]

Sir Ernest Harvey, in whom Bagehot's desire to see an experienced permanent Deputy Governor at the Bank of England seems at last to have been realised, has expressed himself very clearly on this point. He believes it to be a fundamental principle of central banking that " a central bank should be entrusted with the entire banking business of its own Government," and goes on to state his reasons as follows:

" Owing to the inequalities which must exist at different seasons of the year in the amounts of national income and expenditure, it is inevitable that Governments should at times be the holders of considerable credit balances, and at other times be borrowers of substantial amounts. It is only by the concentration of all government transactions in the hands of the central bank that the latter can effect from day to day those adjustments of the credit position which are necessary for the avoidance of constant fluctuations in the supply and value of money." [2]

The Report of the Macmillan Committee of 1931 in England accepted the general opinion in this matter and stated it as follows:

" In practice the tasks which have been imposed on the Central Bank make it imperative that it should hold the account of the Government, for the financial operations of Government are conducted on a scale so great as seriously to derange the money market unless special measures are taken to counteract the inconveniences which result from the inflow of revenue or the temporary easiness which results from interest and dividend payments. This task ought to devolve upon the Central Bank in virtue of its general functions as guardian of the money market, and does in fact devolve upon it when it carries the Government account." [3]

Such categorical statements by high authorities might

[1] Kisch and Elkin, *op. cit.*, p. 104.
[2] Harvey, " Central Banks," p. 19.
[3] Report of the Committee on Finance and Industry (Cd. 3897 of 1931), § 30, p. 16.

seem to settle the question and leave no room for argument, but strangely enough there are other eminent authorities who hold a directly contrary view. Mr. Hawtrey maintains that the Macmillan Committee's view is based on a " palpable misconception." He says :

> " The receipts and payments of the Government only derange the money market *because* the Government keeps its balances with the central bank. . . . If the Government balances were kept with one or more of the joint stock banks, the payment of interest would merely modify the distribution of cash as between one joint stock bank and another, and no disturbance of the money market, as a whole, would be involved." [1]

Much the same view is suggested in the following extract from a very interesting article on central banking in the monthly review published by the Midland Bank :

> " It is customary . . . for the central institution to act as the Government's bank. . . . This arrangement, however, is not vital to the proper fulfilment of central bank obligations. In any fairly highly developed system the commercial banks are quite capable of performing all these services for the Government, possibly with less disturbance to the financing of the trade and industry of the country than occasionally results from their being carried out by the central bank." [2]

The views just quoted are no doubt very logical, and must be given great weight, but they do not seem to be absolutely conclusive. The co-operation of the Central Bank might still be necessary to ensure that Government transactions should not disturb the money market, even if the Government's business were entirely in the hands of the commercial banks. For instance, if one of the big joint-stock banks of London were making the big half-yearly payments of War Loan interest for the Government, it would lose cash reserves very heavily to the other banks through the clearing, and on a scale far out of proportion to anything of the kind that could result from the operations of any other customer. To adjust its position

[1] Hawtrey, *op. cit.*, p. 266.
[2] *Midland Bank Monthly Review*, March–April 1927, p. 1.

without causing undue disturbance it would certainly need to get some temporary assistance directly or indirectly from the Central Bank. Then, again, in a vast country like the United States, with a number of widely separated money markets, it seems clear that large Government transactions on accounts with the commercial banks would be likely to cause relative ease or stringency in the different local money markets if the help of a central banking system were not available to provide for a smooth flow of funds between different parts of the country.

Everyone agrees that fluctuations in Government balances should be prevented from disturbing the money market if possible. To that end the Government should equalise the flow of revenue and expenditure as much as it can, but the fluctuations cannot be smoothed out entirely. The necessity for minimising the influence of the inevitable remaining fluctuations does not provide any clear grounds for a general conclusion as to the relative merits of the Central Bank and the commercial banks of a country for handling Government business.

The three criteria for deciding what to do with Government balances are: (1) safety, (2) convenience in the handling of the Government's financial business, including necessary borrowing, and (3) avoiding disturbance of the smooth working of the money market. As long as there is any appreciable doubt as to the safety of the banks, the Government does well to steer clear of them. Bagehot has put this very well:

> "In the infancy of Banking it is probably much better that a Government should as a rule keep its own money. If there are not banks in which it can place secure reliance, it should not seem to rely upon them." [1]

But in countries with highly developed banking systems to-day there would be little to choose under the headings of safety and convenience between the Central Bank and a really large and sound commercial bank, *e.g.* one of the "Big Five" in England. It is generally

[1] W. Bagehot, "Lombard Street," ed. Withers, 1919, pp. 99–100.

assumed that the credit of the State stands ultimately behind all such institutions, both Central Banks and large commercial banks alike, since it could not allow one of them to fail for fear of financial chaos. As regards disturbances to the money market, their potential size should in theory be less great if the State used the commercial banks only. But since some Central Bank action is likely to be required to prevent them in any case, and as it is generally agreed that suitable Central Bank action can effectively prevent them even if the fluctuations of Government balances occur on its own books, the balance of advantage seems to incline towards making the Central Bank the sole responsible agent for the Government's financial operations. After all, a Government could hardly transfer its business to the commercial banks without dividing it up amongst them, and so losing the great advantages of centralised operation and unified responsibility and accounting; otherwise it would always be in danger of being charged with favouritism.

Before leaving this point, a brief reference should be made to the common belief that Government deposits in the Central Bank are, at least to the extent of the amount of cash held as reserve against them, withdrawn from the use of trade and industry. This idea has been carried over from the days of Independent Treasuries, when such withdrawal might be a most embarrassing fact. But it seems to be quite out of place in these days of credit control by Central Banks. The object of a Central Bank is to create a credit base on which the other banks can extend credit to industry to such an extent as is necessary and desirable by whatever criteria are used for judging the general position. At a given time a Central Bank has a definite policy, and there is a certain total of bank credit outstanding; if then the Government's deposits are transferred to the commercial banks, a new factor arises in the Central Bank's calculations and, other things being equal, it will have to take steps to restrict credit sufficiently to offset the effect of the transfer. Thus the location of the Government's balances cannot in general under existing

conditions affect the ease or stringency of bank credit available for industry. Even an Independent Treasury could perhaps do no appreciable harm now, if the Central Bank were fully informed of its operations and the probable movements of Government balances in the near future in time to carry out any offsetting operations that it might think necessary. But obviously the Central Bank will be much more certain of getting all necessary information in good time, and can do what is required more easily and efficiently if it holds the Government's account itself.

To this general conclusion as to the desirability of the Central Bank's holding all the Government's balances one qualification may be admitted. If by some uniform and simple arrangement, excluding any chance of favouritism, the main Government balances could be held by the commercial banks and withdrawn by the Central Bank only as required in order to meet Government payments and keep the Government balance on its own books at a low fixed amount, this would, no doubt, be ideal. The task of the Central Bank in offsetting fluctuations would be lightened, without any apparent disadvantages, and there would no longer be any possible ground for supposing that the Government's banking methods involved the unnecessary withdrawal of funds from the use of industry. An approach to such a system has been made in the U.S.A. from the time of the Great War; this will be described in detail later.

This general examination of the problem of Government deposits and borrowing so far has shown that there is a diversity of views in this regard. No sufficient reasons have been found for a very decided choice between them. All that can be said is that there is a general presumption that the Central Bank should act as fiscal agent for the Government. This presumption is much strengthened at a time like the present, when most Governments are carrying on extraordinary expenditure on account of the depression, and are therefore absorbing and spending a very large proportion of the national income. The experience and technical ability that

should be available in a strong Central Bank seem to offer the best hope of carrying through such large and unusual transactions with a minimum of fumbling and mistakes.

Of course, it has been maintained at times that a modified Independent Treasury could very well take the place of a Central Bank. By regulating its withdrawal and return of cash from and to the money market by way of bank reserves, it could exercise a general control of credit; it might even make regular advances to the banks at interest and exercise bank-rate policy of a kind, as has happened in Canada, and it could certainly carry on open-market operations after a fashion. A tendency may arise in difficult times for the Government to think that, as the Central Bank has failed to keep the financial machine working smoothly, the Treasury should take control of the main central banking functions and see if it can do better. There is also a suggestion that Governments could make a direct contribution to smoothing out the credit and business cycle by accumulating surplus funds to be invested in Government securities in good times, and selling out these securities in bad times in order to raise extra funds to be spent on public works or other special expenditure with a view to maintaining employment and the volume of purchasing power. History and experience on the whole fail to give much support to the view that Governments can usefully supersede Central Banks and try to exercise direct credit control in this way. Even the U.S.S.R., after destroying the old State Bank in Russia, found it desirable to create another one. Central banking is a difficult art that has not yet been reduced to a routine, and probably never will be. It is unlikely that it can be successfully practised by a Government department, with its codes of rules, strict regard for precedents, and elaborate correspondence "through the proper channels."

This has brought us already to the third heading under which we have to consider the relations of Treasuries and Central Banks: that is, the question of general credit control. Something more elastic and quick-moving than

a Treasury, and more closely in touch with active business, trade and industry, is needed to carry out a credit policy from day to day. If a firm and continuous policy is to be enforced, the institution charged with this duty should also be free from the pressure of political interests in particular matters. It may be assumed, therefore, that a Central Bank is the proper and indispensable instrument of credit control in the general interest.

There remains the question of the best arrangement of relations between the Government and the Central Bank in regard to general credit policy. Even the stoutest adherents of a thorough-going policy of nationalisation would admit that the Central Bank must have a fair degree of independence in the detailed conduct of business if it is to be of any value at all. On the other hand, there must be some means of enforcing the responsibility of the Central Bank to the nation as a whole. Where exactly to draw the line between absolute independence and subjection to rigid control for the Central Bank is a difficult problem. Every kind of solution is being tried; on the one hand, in Russia, the State Bank is one of the Central Bureaus directly responsible to, and forming an integral part of, the executive machinery of the People's Commissariat of Finance of the Union;[1] on the other hand, in England the Central Bank is almost completely free from any kind of legal control by the Government. But we must distinguish here between the form and the spirit. One writer has very justly commented that

> "the governor and directors of the Bank of England . . . actually work in closer harmony with government officials than do the officials of the Reichsbank where the governorship must be approved by the state."

Many important questions could be considered under this heading of the general relations between a Govern-

[1] G. Y. Sokolnikov and Associates, "Soviet Policy in Public Finance," 1931, p. 446.

[2] L. D. Edie, "The Personnel of Central Banks" in *American Bankers' Association Journal*, January 1930, p. 80.

ment and its Central Bank—for example, the method of appointment of the governing body of the Central Bank, the determination of the kind of business it is allowed to do, the limitation and division of its profits, and the powers of the Treasury or the Government in many cases to suspend, disallow or modify its decisions. There is no necessity to discuss all these points here. The greatest variety of practice prevails, and no general rules can be established. A country probably gets, as a rule, the Central Bank that it deserves, just as it gets the Government that it deserves. If public spirit and the standards of morality and intelligence in public life are high, it is likely that both the Government and the Central Bank will be very meritorious and that they will co-operate effectively and satisfactorily, whatever their formal and constitutional relations may be. When a Government is likely to have higher standards than a Central Bank, one would, of course, wish to lay more stress on Government control, whilst if the Central Bank is expected to be more trustworthy than its Government, one might even prefer the independence of a self-electing body of Directors responsible only at the bar of public opinion.

The problems of central banking are closely connected with those of national economic planning in general. They are certainly in a very dynamic condition just now and, so to speak, very much "in the air." No one can tell what developments the near future may bring. One may hazard the prophecy that some fresh organisation of the whole economic side of our social activity will be needed if "planning" is to become really satisfactory. Perhaps the responsibility and co-operation of the Central Bank in a sound "planned economy" may be directed towards some new central economic authority in a position largely independent of the political government. Even then much the same problems as to the adjustment of powers and detailed relations between the Central Bank and the central economic authority will still remain.

The best form of relations between the Government

and the Central Bank in any country depends always on the particular circumstances of that country. Much can be learned by study and comparison of existing relations, but nothing can be transferred wholesale without careful consideration of differences in environment and national character. The importance of this subject at the present time does not need to be stressed. Since no general rules can be established, it is all the more important to study carefully the actual experience of countries which seem to have had a considerable degree of success or to have made notable experiments in this field. Though their results cannot be used elsewhere ready-made, they should still be given much weight; something may often be gleaned from them that can be usefully adapted to different conditions.

We shall therefore now proceed to examine in some detail the relations between the Governments and the Central Banks in two of the more important countries, as they have developed historically and as they now exist. The United Kingdom and the United States of America have been chosen for this detailed study, because of their special importance in the evolution of central banking and modern financial practice.

CHAPTER II

THE UNITED KINGDOM, (*a*) HISTORICAL

THE many-sided work and quaint old customs of the Exchequer in mediæval England make a fascinating story that can only be briefly touched on here.[1] The Treasury as a place for keeping the King's valuables no doubt goes back to the time of the earliest Kings, and the title of Treasurer may have been in use before the Norman Conquest for the official who had charge of the store of treasure in the King's Palace. But the regular organisation of the King's financial business in the two chambers of the Exchequer took place under the Norman Kings, just as it did a little later in their other territory of Normandy. This may perhaps be regarded as one aspect of the growth of a money economy. The term Exchequer (" scaccarium," from the same root as chess and checkers) is connected with the use of a large table (rather like a modern billiard table) covered by a heavy dark cloth bearing lines drawn in chalk for use in calculating with counters on the abacus method when auditing accounts. Poole has shown that this new procedure was begun by Norman officials in England in the reign of Henry I, and was in use in 1118. A full account of the working of the Exchequer System called the " Dialogus de Scaccario " was written in 1177–8 by Richard, son of Nigel, Bishop of London, an eminent Treasurer and a member of the most important family of Norman officials in twelfth-century England.

The Treasurer (long a cleric, as few laymen could read and write) and his clerks were an essential part of the Ex-

[1] Interesting details can be read in the works of Madox, Thomas, Hall and Poole included in the Bibliography.

chequer in the Middle Ages. From the thirteenth century, when the King in person and his representative, the Justiciar, ceased to attend and supervise its business, the Treasurer became the head of the whole organisation. But in the sixteenth century, in the time of Queen Elizabeth, the Treasurer, Lord Burleigh, was the Queen's chief Minister, and naturally was too busy to attend regularly at the Exchequer. He began that practice of sending his instructions through a secretary, which caused the modern Treasury Department to separate itself off from the Exchequer and practically to replace the latter in the general supervision and control of the State finances. Thus in a sense the Treasury is older than the Exchequer, but it is also quite correct to say that the modern Treasury developed out of one part of the mediæval Exchequer.

The "upper" Exchequer, or Exchequer of Account, met twice a year, at Easter and Michaelmas, to settle the accounts of the sheriffs and some other local officers. Each sheriff was responsible for the King's revenue from his own county, and his account was very carefully recorded in the "Great Roll" or "Pipe Roll" every year. Calculations were made by moving counters on the Exchequer table, but in the fifteenth century this developed into a special use of "pen-and-ink dots," used only by Exchequer officials and last found in 1676.[1]

Originally all the great officers of the Court—the Justiciar, the Chancellor, the Constable, the Marshal and the Chamberlains, as well as the Treasurer—took part in person in the Exchequer sessions, and in theory all *barones* or tenants-in-chief were entitled to be present. Most of the great officers soon dropped out or were represented in practice by deputies, *e.g.* the Deputy Chamberlains. From the thirteenth century the chief officials actually controlling the Exchequer were the Treasurer and the four (or sometimes five) permanent appointed "Barons of the Exchequer." The Chancellor's

[1] H. Hall, "Antiquities of the Exchequer," 1891, pp. 127–31.

place was taken by his clerk, who supervised the writing of a duplicate of the Great Roll as a check on the Treasurer. This clerk became the "Chancellor of the Exchequer," who from the time of Henry VIII was also appointed Under-Treasurer, and therefore belonged to the Treasury Department when it became separate. The Treasury was first placed in commission by James I in 1612, and this arrangement became permanent early in the eighteenth century. Since then the First Lord Commissioner of the Treasury has been the Prime Minister, and, like the "Junior Lords," he has had only a formal connection with the regular financial business of the Treasury. The real head of the Treasury has been the Chancellor of the Exchequer, who is the Second Lord.

The Exchequer of Account in one aspect developed into a regular Law-Court; as the Exchequer of Pleas, dealing at first only with legal disputes connected with the King's financial business, it has a long and interesting history, ending only in 1873. Its functions in the auditing of public officers' accounts probably reached their maximum in extent and efficiency in the fourteenth century, when the accounts of national services such as the military forces and the collection of customs were brought within its scope. Thereafter came stagnation and deterioration, so that in Tudor times the audit procedure through the Exchequer was felt to be cumbersome and inefficient. Several new officers were established at different times to deal with some branches of revenue on improved lines with more summary methods of audit. These were abolished and the work was taken over again by the Exchequer in the reign of Mary. But Elizabeth in 1560 again appointed two Auditors of the Prests ("imprests" or advances from the Exchequer for public expenditure) to audit the accounts of certain departments independently. There was much controversy as to the final disposal of accounts audited by them. The Imprest Auditors thought it sufficient to preserve them themselves, whilst the Exchequer officials, not unin-

fluenced probably by the effect on their fees, insisted that they ought to follow the "ancient course" of the Exchequer. It was finally decided that after these accounts were "declared" at the Treasury a definitive copy should be forwarded to the Exchequer, to be recorded in abstract by the King's Remembrancer and the Treasurer's Remembrancer and the Clerk of the Pipe.[1] These two Auditors of the Prests were succeeded in 1785 by the Commissioners for auditing the Public Accounts, who, under Statutes of 1832 and 1833, absorbed all the auditing work of the Exchequer of Account. After more than seven centuries of life, the Exchequer of Account finally disappeared in 1833; the more or less sinecure offices of the Surveyor of the Greenwax, the Clerk of the Nichils, the Foreign Apposer and many such others were suppressed, and the long series of annual Pipe Rolls came to an end.[2]

The "lower" Exchequer, or Exchequer of Receipt, lasted up to the passage of the Exchequer Act of 1834, and in a way still exists in the form of the Exchequer Account at the Bank of England, and the office of Comptroller and Auditor-General. It was still in full vigour in the seventeenth century, when a banking system first grew up in England. A recent study of some of its copious but neglected records has helped to throw a good deal of light on the relations between the State and the earliest English bankers.[3] We shall find that the process by which the essential functions of the Exchequer of Receipt were gradually taken over by the Bank of England

[1] Mrs. Eric George, "Notes on the Origin of the Declared Account," in the *English Historical Review*, Vol. 31, pp. 41–58. The article assumes that the Auditors of the Prests formed part of the Exchequer, but this seems to be incorrect. Cf. article "Exchequer" in "Encyclopædia Britannica," 14th edition.

[2] F. S. Thomas, "The Ancient Exchequer of England," pp. 23, 126.

[3] D. R. Richards, "The Early History of Banking in England," *passim*. Some account of the records of the Exchequer of Receipt will be found in H. Jenkinson, "A Manual of Archive Administration," London, 1922, pp. 206–22, and in M. S. Guiseppi, "A Guide to the Manuscripts Preserved in the Public Record Office," London, 1923, Vol. I, pp. 178–97.

in the eighteenth century is of the greatest importance in the development of the Bank's relations with the Government.

The chief officials of the Exchequer of Receipt in the seventeenth century were the Clerk of the Pells and the Auditor of the Receipt (or Writer of the Tallies), who were originally clerks of the Treasurer, the two Deputy-Chamberlains and the four Tellers. The duties were in practice mostly performed by clerks or deputies appointed by these officers to act for them. The Clerk of the Pells (parchment rolls) made the authoritative record of all receipts and payments in the " Introitus " and " Exitus," *i.e.* the " Receipt Roll " and " Issue Roll," and also recorded the various Writs under the Privy Seal, Treasury Warrants, etc., giving authority for the payment of money. The Auditor kept similar records, on the old principle of having copies kept by different officers as a check on one another. He issued the periodical " debentur " (debenture), under which an official or pensioner with a claim on the Exchequer under a standing authority could obtain payment. The claimant then often drew a demand note in favour of another person. Such notes were essentially cheques on the Exchequer, and were in use forty years before there is any record of the use of bankers' cheques. The Auditor also attended to the issue of Treasury payment orders under special authority. On presentation every such order had to be endorsed with his payment order to one of the Tellers and with the " Recordatur " of the Clerk of the Pells before payment could be made.[1] The duty of writing tallies, according to the ancient custom to be described shortly, also remained in the Auditor's department.

The Deputy-Chamberlains were chiefly concerned with the cutting and custody of tallies. The clerks of the four Tellers handled the cash itself in the " Tellers' loft " above the " Tally Court." The cash balance of each Teller was kept in a separate chest with three locks, the keys of which were held by his clerk, the Clerk of the

[1] Richards, pp. 52–7.

Pells and the senior Deputy-Chamberlain respectively. The Auditor also verified the balances at intervals.[1]

When a payment was made to a Teller's clerk, he wrote a Teller's bill, which was thrown down a pipe so as to fall on the table in the Tally Court. There the proper entries were made in the various records and a tally was cut to serve as a duplicate receipt. Keeping accounts by notching sticks was a very widespread practice, but nowhere so elaborately developed as in these Exchequer tallies. A stick of hazel was roughly squared and notches were cut on it to represent the sum paid; a notch of a certain shape and width stood for £1,000, a smaller notch for £100, and so on. The Auditor's clerk would then write details of the payment in abbreviated Exchequer Latin on two sides, and the stick would be split through the notches. One part, called the tally or foil or stock, was given to the person paying in the money, and the other part, the counter-tally, was retained in the custody of the Deputy-Chamberlains. This system of cutting tallies continued in use at the Exchequer till 1826, when written receipts were substituted. The burning of the accumulated tallies in 1834 probably caused the fire that destroyed the old Houses of Parliament.[2]

The ordinary receipt tally was called a tally of sol, because "sol" (standing for "solutum," *i.e.* paid) was written on it. Another kind of tally was the tally of pro, also known as a tally of assignment or anticipation. This was struck pro, *i.e.* for the benefit of, a person having a claim for some payment at the Exchequer, and operated as an order to a collector of revenue to pay him the amount stated. Such tallies seem to have been used from the earliest times; the sheriff concerned would pay the

[1] Thomas, pp. 128, 132, 139. Samuel Pepys was second clerk to one of the Tellers, 1658–60, and many glimpses of his work there, which was decidedly light, are given in the first part of his diary. See A. Bryant, "Samuel Pepys," New York, 1933, pp. 45–9, 110.

[2] Thomas, p. 26. Articles by H. Jenkinson on "Exchequer Tallies" in *Archæologia*, Vol. LXII (1911), pp. 367–80, and H. de Fraine on "Tallies" in *The Old Lady of Threadneedle Street*, Vol. II, No. 13 (March 1924), pp. 178–87, contain interesting details about tallies.

holder and present the tally later to be offset against the amount due from him. But the amount was entered at the Exchequer as both received and issued at the date when the tally was struck. The revenue was anticipated by this means, and the tally of pro represented a loan by the holder till he received payment. The tally of sol might equally represent a loan, if the amount were paid in to the Exchequer in cash. Such a tally was called a tally of loan, and had to be produced and verified at the Exchequer to obtain repayment in due course. Thus both the tally of sol and the tally of pro could be used, and actually were used from very early times, to cover loans in anticipation of revenue.[1]

Queen Elizabeth and the early Stuarts used a different method of borrowing, on Privy Seal demand notes, usually bearing ten per cent. interest. They were distributed through "collectors,"[2] and were assignable and payable at the Exchequer in due course; presumably the collector paid in the proceeds to the Exchequer and received ordinary receipt tallies. The London goldsmiths, some of whom were important bullion-merchants and money-lenders under Elizabeth, became regular bankers during the time of the Commonwealth. Their existence made possible an extraordinary development at the hands of Charles II of the system of anticipating revenue by means of tallies. The breakdown of this system in 1672 resulted in the beginning of the permanent National Debt and also, by injuring the credit of both the Government and the private bankers, prepared the way for the foundation of the Bank of England.

The most eminent London banker in the period 1660–72 was Alderman Edward Backwell. It is said that he acted as a reserve bank and clearing-house for the other goldsmith bankers. Already in 1658 he had an account in the name of "The Commonwealth of England," and made a large advance to the Government

[1] Parliamentary Papers, 1868–9, Vol. XXXV (366), App. 13, pp. 338–40, and 1857–8, Vol. XXXIII (443), pp. 84–9.
[2] Richards, pp. 5, 7.

on which instalments were punctually repaid. He was one of many bankers who invested heavily in Charles II's public floating debt, and it is interesting to note that he kept the King's private account.[1]

Dr. W. A. Shaw has very vividly described the difficulties experienced by Charles II in the first half of his reign through the failure of the supply granted by Parliament to cover the national expenditure.[2] This resulted in a rapid increase of borrowing on tallies, and some changes in the system with a view to greater convenience. In 1660 an Act of Parliament (12 Chas. II, c. 9) authorised the payment of interest on tallies of loan. In the same year (12 Chas. II, c. 13) the legal rate of interest was fixed at 6 per cent. As this was far below the market rate, it became usual up to 1671 for the King to pay an additional four per cent. or so under the name of gratuity or reward.

When granting an Additional Supply in 1665 for the Dutch War (17 Chas. II, c. 1) Parliament provided that each tally of loan issued on this security should be accompanied by a repayment order (written on parchment, and usually known as an " order of loan ") which should be transferable by endorsement. These orders were to be registered in the Exchequer and paid off in order in due course—as the money came in. Similarly, persons who would provide goods required for the Navy on this security were to be given Treasury payment orders which were registered and transferable in the same way. This is the

[1] Richards, pp. 30, 32, 211. The statement on p. 30 that he was a State banker under Charles II, is hardly justified by the fact cited that he held the account of the " Farmers of the Customs " and paid out amounts from their balances for the public service. They were free to keep their money as they liked, and he would pay orders on them only on their authority and responsibility. However, he was employed on State business directly as receiver of the proceeds of the sale of Dunkirk and also of the cash portion of the Queen's dowry from Portugal. See Calendar of Treasury Books, ed. Shaw, Vols. I to III, *passim*.

[2] See his introductions to Calendar of Treasury Books, Vols. I to III, and also his article on the " Treasury Order Books " in the *Economic Journal*, Vol. XVI, 1906, pp. 33–40.

first Parliamentary authority for the issue of negotiable public securities bearing interest. The arrangement proved so convenient that in 1667 all orders registered in the Exchequer for payment out of future revenue were made assignable in this way.[1]

There followed in the years 1667–71 a regular flood of these "orders of the Exchequer" which did not represent money received in the Exchequer. They were supplied in large amounts to the Treasurers of the Navy and other public accountants "by way of Imprest and upon Account." The latter assigned them as security for loans from the goldsmith bankers or paid them away to the public creditors, who seem usually to have discounted them with the goldsmiths.[2] As a rule, these orders were registered on a certain branch of the revenue, *e.g.* the Customs, the London Excise, the Country Excise or the Hearth-money, but some were merely "charged on the Exchequer in general,"[3] and hence less satisfactory.

Dr. Shaw maintains that these orders were all "fictitious orders . . . not representing any actual transaction . . . in fact, only so much paper credit," and he thinks that "it is no exaggeration to say that this is the origin of official paper money in England."[4] Though these orders do not seem to have been accompanied by tallies, it is evident that they are only a development of the old tally of pro. They were no more "fictitious" or "fiduciary" than the repayment orders and no less; when paid out to the public they represented cash or goods or services received. They were for large amounts as a rule, and did not circulate as paper money, but accumulated in the hands of the bankers. In fact, they were essentially short-term Government securities resembling the modern Treasury bill or certificate.

[1] Parliamentary Papers, 1857–8, Vol. XXXIII (443), pp. 90–91.

[2] Richards, pp. 60–63. A specimen "fiduciary order," as he calls it, is there printed on p. 63.

[3] See Calendar of Treasury Books, Vol. III, p. 1364, for two examples in December 1671.

[4] *Economic Journal*, Vol. XVI, 1906, p. 40.

The piling up of a floating debt when there is a chronic gap between revenue and expenditure soon leads to a crisis. By January 1672 Charles II had mortgaged the future revenue up to about one and a half years ahead. For want of any other way of financing the third Dutch War, he resorted to the curiously modern device of freeing the current revenue by a compulsory funding of the floating debt.

The "stop of the Exchequer" in form prohibited the Exchequer from paying any tallies or orders charged on the revenue with certain general exceptions, and reserving the King's right to order payment in particular cases. But the general effect seems to have been that the default affected in the main only the bulk of the orders held by the bankers. Regular interest at six per cent. was promised, and paid for about two years in 1675 and again from 1677 till 1683. Twelve years of litigation resulted in a judgment against the Crown; an Act of Parliament of 1701 then provided for the resumption of payments of interest in 1705, but only at three per cent. and subject to redemption on payment of half the principal. The bulk of the "bankers' debt" stock was subscribed for South Sea Company stock in 1720, and a small remainder was paid off in 1723.[1] Thus via the South Sea Company's stock most of it became part of the permanent funded debt, and by compulsion "the creditors of the goldsmith bankers became the first investors in the English National Debt."[2]

[1] Richards, pp. 66–7 and 77–81. It is there shown that the goldsmiths' accounts were carefully worked out in the Exchequer, and that most of them still exist in two books in the Exchequer Records. In 1677 the bankers were ordered to make assignments of proportionate amounts of interest to the depositors, whose money they had invested in Exchequer orders. The registers of these assignments also exist among the Exchequer Records. Dr. Richards makes a mistake on p. 66 in repeating the usual statement that "Charles II duly paid this annual interest," and implying that payment was stopped by his successor. For correct details see Feavearyear, "The Pound Sterling" (1931), p. 105. Tallies were issued for the interest up to 1683, when Charles II stopped issuing them because of the heavy arrears of payments due on tallies already issued.

[2] Richards, p. 81.

Parliament forbade the issue of tallies of pro in 1677 with reference to a special grant, and in 1689 generally for all appropriated funds.[1] But tallies continued in constant use, caused great difficulties through over-issue under William and Mary, and only gradually fell into disuse in the eighteenth century as Exchequer Bills were found more convenient. Departmental payments were largely made by tallies again during the War period, 1689–1714. Of the goldsmith bankers whose credit suffered from the "stop of the Exchequer," several, including Backwell, went bankrupt at various dates between 1679 and 1715. But others survived and new ones came into prominence, so that the group as a whole was as important and prosperous as ever at the end of the seventeenth century.[2] Meanwhile, a great variety of schemes was being put forward for the formation of a large bank in England, and much attention was given to the large, successful banks in northern Italy (Venice and Genoa) and northern Europe (Amsterdam, Hamburg, Stockholm, etc.). With the establishment of constitutional government in 1688 the time became ripe for some such enterprise in England; till then there would have been a real danger of its becoming a tool, willing or otherwise, in the hands of a would-be absolute ruler.

Like the "stop of the Exchequer," the Bank of England was a device, though a much happier one, for financing war expenditure at a time when the accumulation of floating debt had made the position almost desperate. In fact, the device was almost precisely the same, the creation of a debt on which only the regular payment of interest was promised, with no obligation to repay the principal except on the termination of the Bank's charter. The difference in applying this scheme lay in inviting

[1] Parliamentary Papers, 1857–8, Vol. XXXIII (443), p. 95.

[2] Richards, pp. 24–5 and 87. It appears that after 1672 the goldsmith bankers avoided putting all their eggs into one basket. There was only one of them, Duncombe, who, both individually, and with his partner, Kent, made large advances to Government in the period 1672–1700. See Feavearyear, p. 106, and Richards, pp. 86, 87.

voluntary subscriptions instead of compulsorily converting the floating debt.

The Bank was originally, in Bagehot's phrase, a "Whig finance company" formed to support the Government of William III and to help to carry on the struggle against France. The Tonnage Act of 1694, which authorised it, was concerned with granting money to the King and raising it in various ways. One way was the promise of incorporation as "the Governor and Company of the Bank of England" to such persons as should subscribe £1,200,000 to be lent to the Government in return for an annuity of £100,000 representing interest at eight per cent. and £4,000 allowance for the expense of managing the debt. The required amount was subscribed in ten days, and the Bank opened for business in July 1694.

The system of borrowing money by the sale of terminable annuities had been introduced by William III's Government in 1693, but this original debt to the Bank is the oldest part of the permanent funded debt except the "bankers' debt" already described. The floating debt also was closely connected with the Bank from the time of its foundation. Michael Godfrey, the first Deputy Governor, claimed soon after the Bank opened that tallies had become "better than money," since they earned seven or eight per cent., and could be cashed for their face value plus accrued interest at any time at the Bank, whereas a year earlier cash could only be raised on them at a discount of one to thirty per cent., varying with the nature and remoteness of the revenue on which they were charged. The Bank was prohibited from making loans to the Government without the consent of Parliament, but no special permission was needed for it to buy tallies of loan for which Parliament gave a general authority when granting the revenue. Godfrey says:

> "The Bank gives money for tallies on funds, having a credit of loan by Act of Parliament, and which are payable in two years time, for the growing interest only, without any other allowance." [1]

[1] Francis, "History of the Bank of England" (1848), Vol. II, p. 243, Godfrey's able pamphlet "A Short Account of the Bank of England"

Within a few days of its establishment the Bank was in possession of five tallies amounting to £112,000 which had presumably been discounted or accepted as deposits. A week later it decided to discount others on various funds up to not more than £2,850,000.[1] In the years 1694–6 the Bank was also engaged in making large transfers of money to the Low Countries for the Government for war purposes; in this connection it maintained for some time a "House at Antwerp" with several of the Directors in residence.[2]

It seems at first sight very strange that a bank so intimately associated from the first with Government finance should have been in form a purely private company, free to operate as it thought fit within the general limitations laid down by its charter, and without any kind of Government control or guarantee. Large banks on the Continent up to then had usually had a State or City guarantee. Professor Foxwell has pointed out that the credit of both the Government of England and the City of London was very low in 1694.[3] Probably the Bank's credit would have suffered from any formal connection with either of them. Its constitution was similar to that of the other big companies chartered in England before and after it, comprising a Governor, a Deputy Governor, a Court of Directors (twenty-four in number) and a Court of Proprietors. Godfrey stresses the fact that

> "any nine members, having each £500 stock, may call a general court, and turn out the governor, deputy governor and all or any of the directors and choose others in their places." [4]

The Bank was authorised by the Tonnage Act to issue

(1695) is there reprinted as App. I, pp. 241–57. Godfrey was killed by a cannon-ball on July 17th, 1695, when visiting William III in the trenches before Namur to discuss the remittance of money by the Bank. See Francis, Vol. I, pp. 71–2.

[1] Richards, pp. 138, 154.

[2] *Ibid.*, pp. 179–88.

[3] Introduction to Philippovich, "History of the Bank of England" (1911), pp. 7–8.

[4] Francis, Vol. II, p. 242.

" sealed bills " to an amount not exceeding its capital; these at first bore interest at twopence a day on £100 (about three per cent. per annum), but by 1698 they were being issued without interest. The Act made no mention of other kinds of bank-note, and the Bank seems to have been advised that it was free to use other kinds without restricting the total issues to the extent of its capital. The most important of these was the running-cash-note, similar to the goldsmith's promissory note and the real precursor of the modern bank-note. Presumably these notes at first normally represented deposits of cash, on which the Bank is said to have paid interest at four per cent. for some time.[1] But it is a most interesting and significant fact that both sealed bills and running-cash-notes on a fiduciary basis were used to pay in the greater part of the original loan to the Government. The whole of the £1,200,000 was paid in to the Exchequer by the end of 1694 as required by the Act, but only sixty per cent. of the capital, or £720,000, had been paid up by then, and the rest was not called for till 1697.[2] Bank of England notes were not legal tender, but it seems clear that at that time the Government accepted them and paid them out as cash, and did not send them to the Bank to be changed for metallic money. Early in 1695 the Bank paid in further amounts totalling nearly £650,000 towards temporary loans to the Government,[3] presumably also in notes.

The years 1696–7 were very critical for the country and the Bank. Debt was piling up, and there was the greatest difficulty in finding the money for the war with France. Tallies again went to a heavy discount, which was as much as forty per cent. when the Bank Act of 1697 was passed.[4] The exchange value of English money fell very low owing to the bad condition of the coin in circulation, which was mostly " clipped," together

[1] Andréadès, " History of the Bank of England," 1909, p. 85.

[2] Richards, pp. 149–58. Dr. Feavearyear (*op. cit.*, p. 116) seems to be mistaken in saying that £720,000 was paid to the Government in cash.

[3] Richards, p. 150. [4] *Ibid.*, p. 147.

probably with an over-issue of notes by the Bank.[1] The failure of the unfortunate and still-born Land Bank scheme in 1696 was damaging to the Government's credit, whilst the prospect of a rival institution established by Parliament had injured that of the Bank. The long-delayed re-coinage of silver money had to be undertaken in 1696, and caused a great shortage of cash, so that the Bank partially suspended cash payments and its paper was at a heavy discount from May 1696 to September 1697.[2] The first published statement of the Bank's affairs, dated 10th November, 1696, became available through a Parliamentary inquiry in December; it shows liabilities (apart from capital) of about £2 millions, of which about seven-eighths was covered by holdings of tallies, whilst the cash was only £35,664, not including goldsmiths' notes for £9,637.[3]

Through all these difficulties the Bank stood loyally by the Government. After the failure of the proposals for the Land Bank it borrowed from the Bank of Amsterdam and from its own proprietors, and advanced £540,000 to the Government in June and August 1696.[4] It does not seem to have raised any objection to the issue from July 1696 of Exchequer bills, which were essentially interest-bearing Government paper money competing with its own bills. The first issue amounted to only £159,169 out of £1,500,000 authorised; less than £60,000 remained outstanding by the end of the year, perhaps because they were made payable at the Exchequer on demand. In 1697 £1,500,000 was put into circulation, chiefly in £10 and £5 bills, and the Bank actively co-operated in achieving this; the business of keeping them convertible at par was put in the hands of trustees, including five of the Bank's directors. These bills were made receivable for taxes by a recital on their face (as

[1] Rogers, "The First Nine Years of the Bank of England," pp. 88, 165–69. Feavearyear, p. 125.

[2] Rogers, pp. 66, 170.

[3] Commons Journals, Vol. XI, pp. 612, 614, 616, 621–22.

[4] Andréadès, pp. 108–9.

the first issue also had been by Treasury instructions); they were not made payable at the Exchequer, but tax collectors were to cash them out of tax collections if requested.[1]

At the end of 1696 unredeemed tallies amounted to over £8 millions, and it was calculated that the funds on which they were charged would fall short of this by some £5 millions.[2] The faithful Bank was again called into the breach, but it received in return important privileges by the Bank Act of 1697. Its capital was increased by about £1 million to be subscribed four-fifths in Exchequer tallies and one-fifth in bank-notes. This new capital was gradually repaid to the subscribers by the Bank over the period 1698–1707. The Act of 1697 first gave the Bank a monopoly, providing that so long as the Bank of England lasted, no other bank should be established or allowed in England by Act of Parliament. There were to be no more Land Banks! The date at which the Government reserved power to give a year's notice to repay the original capital and terminate the corporation was also advanced from 1705 to 1710.

This Act, with other favourable events such as the peace with France, and the successful progress of the re-coinage, in which the Bank acted as a Government agent for calling in and issuing coin, brought about a satisfactory state of affairs by the end of 1697. Exchequer tallies are said to have risen from fifty per cent. below par to twelve per cent. above.[3] The Bank had weathered its first great storm, and had been of the greatest assistance to the Government and the country at a time of severe strain. Its position was now firmly established as a loyal, but by no means a subservient, auxiliary of the Government, with every prospect of increasing success and usefulness so long as its prudent management continued and there was no return of the Stuarts.

[1] Richards, pp. 141–3. Parliamentary Papers 1857–58, Vol. XXXIII (443), p. 95. Philippovich, pp. 97–9. For the Treasury instructions of 1696 see Calendar of Treasury Books, Vol. XI, pp. 47, 196.

[2] Philippovich, pp. 93–4.

[3] Andréadès, p. 112. No authority is given for these figures.

It is not necessary here to trace the history of the various renewals of the Bank's charter in the eighteenth century. Each was the occasion for negotiations and the striking of a bargain by which the Bank as a rule increased its permanent loan to the State and reduced the rate of interest or made an advance for a period without interest. More interesting is the position that the Bank attained, more by custom and precedent than by legal prescription, in the management of (1) public borrowing and the National Debt, and (2) the receipt and payment of public money.

Exchequer bills continued to circulate as currency till early in the nineteenth century; it is said that they had ceased to do so by 1825.[1] The issue of 1707 was placed under the management of the Bank; after that the same arrangement was always followed, with the exception of some transactions with the South Sea Company in 1719–20. Repeated contracts were made by the Bank with the Government from 1707 to be responsible for fixed amounts of these bills bearing a stated rate of interest, and to maintain a certain cash reserve to ensure their convertibility, in return for which it received a percentage allowance on the amounts outstanding. Further amounts were not to be issued without the consent of the Bank. Practically each contract amounted more or less to a loan from the Bank, repayable after a certain notice, and covered by the issue of Exchequer bills, which circulated in the same way as bank-notes and were gradually redeemed by the Bank. Sometimes the amount was never repaid by the Government, but was added to the permanent debt to the Bank in return for an increase in its annuity. From the time of George II, Exchequer bills were used every year under parliamentary authority to anticipate the land and malt taxes; they took the place of the old tallies of loan, and "became the basis of the credit allowed by the Bank to Government for the purposes of current expenditure."[2] Thus the floating debt was put on a relatively sound footing, and became a

[1] Feavearyear, p. 221. [2] Philippovich, p. 111.

regular and important part of the business of the Bank of England.

This close and unbroken association of the Bank with the Government in the matter of Exchequer bills must have been a strong influence in the evolution of the Bank's special position in regard to the funded National Debt. The transfer of the Exchequer bills to the Bank's management probably seemed to contemporaries merely a matter of convenience, and of using the Bank's credit to assist in a public object. But there may have been, at least subconsciously, some recognition of the need for a single control of note-issues and the advantage of making an experienced and reliable bank rather than a Government department responsible for maintaining convertibility.

Within twenty years of the foundation of the Bank, two other great chartered companies were formed under Acts of Parliament with very similar relations to the Government in the way of permanent debt and a guarantee of privileges unless the Government should repay the debt. They were, however, strictly prohibited from doing banking business, and this fact was of great significance for future developments in the relations of the three companies with the Government and the National Debt.

The East India Company, which had existed from 1600, was unwilling in 1698 to advance a loan of £2 millions at eight per cent. to the Government. A rival company was therefore formed to do this, and was given the same privilege of trade with the East Indies. By 1709 the two companies became completely amalgamated, and the total Government debt to the East India Company stood at £3·2 millions at five per cent.[1]

The South Sea Company was formed in 1711 to fund a floating debt of about £9 millions (mainly departmental arrears and bills issued by departments to their creditors) in return for an annuity at five per cent. Its trading rights turned out in the long run to be worthless, and

[1] Philippovich, p. 90.

after incurring losses on its trade for some time, it gave up trading entirely in 1748, and became a company concerned only with the holding and management of Government debt.

Meanwhile, as everyone knows, the absurd speculation in the Company's stock caused the "South Sea bubble" of 1720. At this time it took over the bulk of the existing Government debt except that to the other two companies. This was done by voluntary subscription of the holders, and at the height of the boom £1,000 in money or Government debt was being subscribed for £100 stock in the South Sea Company. The Bank of England was fortunate in getting through this hectic time scatheless. It had competed with an offer for taking over the debt on terms that would have been disastrous, but the South Sea Company went higher. Before the final collapse the Bank agreed to take over part of the South Sea Company's stock on terms that would also have been ruinous, but was able to draw back on a technicality.[1] Finally, in 1722, as part of the reconstruction measures, the Bank took over £4 millions of the Company's stock on reasonable terms; on this the Government paid five per cent. until 1727, and then four per cent.

In considering the relation of these companies to the National Debt one must always be careful to distinguish between (1) Government debt owned by a company, and (2) Government debt which it managed as an intermediary, receiving subscriptions, registering transfers and paying interest, etc., as an agent of the Government. The "company-owned" debt became part of a company's capital stock, but might originate in different ways, by the purchase of short-term obligations which were afterwards funded, by a direct long-term loan to the Government, or by taking over existing Government debt on terms arranged with the holders and the Government. In the "company-administered" debt, which was a later development, the company concerned had, of course, no

[1] Andréadès, pp. 130, 137.

proprietary interest; it merely took the place of a Government department in performing certain administrative functions.

The East India Company played only a minor rôle as to Government debt, and that only in the field of "company-owned" debt, as we have called it. £1 million was advanced to the Government when the Company's Charter was renewed in 1744, making a total debt of £4·2 millions. In 1793 the whole of this amount was combined with the "three per cent. reduced annuities" under the administration of the Bank.[1]

Till 1751 the South Sea Company kept its lead in regard to the National Debt. In 1733 the three companies owned or managed almost all the funded debt, and the South Sea Company owned or managed about £29 millions against some £13 millions held by the other two together. But after the events of 1720 it was a long time before any fresh money was raised through this Company. In 1722 and 1733 the bulk of its holding was converted into negotiable annuity stock, which was placed on the market, though it remained under the Company's management. In 1751 an amount of £2·1 millions was borrowed through the Company on three per cent. annuities and added to its "administered" debt. The total amount of Government debt owned and administered by the South Sea Company in 1751 was just over £27 millions. From then on repayments were gradually made, whilst there were no additions.[2]

The "administered" debt originated at the Bank, and the amount handled there grew continuously and at times very rapidly. The Bank was first employed to receive subscriptions for a lottery loan in 1710. From 1715 it received subscriptions for ordinary annuity loans at intervals, and was also entrusted with the regular payment of the annuities on most of these loans.[3]

[1] Philippovich, p. 125. [2] *Ibid.*, pp. 124, 129–30.

[3] *Ibid.*, p. 134. Richards, p. 192. Cf. Francis, Vol. I, p. 101, where the date seems to be incorrect: "In 1718, subscriptions for government

Henry Pelham carried through a noteworthy conversion scheme in 1750, by which the interest on the whole debt was reduced to three and a half per cent. and fell to three per cent. in 1757. This was followed in 1751 by a reorganisation of the annuity debt (apart from the South Sea annuities and a small residue of Exchequer annuities) into a few large funds under the administration of the Bank. The "administered" debt for the Bank now came to about £28 millions, whilst the amount owned by it was about £12 millions more. Thus the Bank had definitely passed the South Sea Company in the race by 1751. From that time it became the established practice to issue new loans through the Bank, and by 1880 its "administered" debt totalled £393 millions.[1]

Occasionally there were suggestions that some other mode of administration might prove cheaper; nothing, however, came of them except some reduction in the rate of allowance made to the Bank for this service. Thus in 1781 the Audit office suggested that an independent Government office could manage the National Debt much more cheaply, whilst in 1797 a House of Commons Committee thought that perhaps the South Sea Company's functions might be extended for that purpose.[2] After that no more such proposals were heard. The Bank and the Government always found it possible to agree on a rate of payment for the service which was reasonably satisfactory to both parties. In 1808, in view of the very great increase in the National Debt, and after careful investigation, an agreement was made by which the rate was reduced and was to vary according to the total amount of the debt. Besides the annual payments for manage-

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loans were first received at the establishment; and this practice being beneficial for various reasons, is still continued." Calendar of Treasury Papers, 1720–28, p. 358, shows that many years later the accounts were being settled for the management of the 1710 loan, and the Bank was making a claim for payment for the service.

[1] Philippovich, pp. 133–7.

[2] *Ibid.*, pp. 131 and 143.

ment, the Bank also received special payments at the time of receiving subscriptions for loans.[1]

There is no need to give further details here of the relation of the Bank to the permanent National Debt. Its function as manager of the debt was practically secure from 1751, and after the end of the eighteenth century was not questioned even in theory. The principle of management through the Bank was admitted by all. Something more will be said later about the relation of the Bank to the floating debt along with the general subject of credit control. At present we shall turn to consider the Bank's connection with the Government's cash balances.

When the Bank was founded in 1694, Government cash balances were held by three different sets of people: (1) the receivers and collectors of the various heads of revenue, (2) the Tellers of the ancient Exchequer of Receipt, and (3) the officers who received advances of money (imprests) to be expended on authorised public services and accounted for later. The most important members of this last class were the Paymaster-General of the Forces (for the Army), the Treasurer of the Navy, and the Treasurer of the Ordnance; it will be convenient to call these three officers collectively the "paymasters." Thus there were not only Exchequer balances, but also the very important receivers' balances and paymasters' balances, all of which were destined to pass in time into the hands of the Bank.

In the seventeenth century, and particularly after the Restoration, most of the branches of the revenue were organised as separate administrative departments under the general control of the Treasury. Thus the Customs, Excise, Stamp Tax, Post Office, etc., each had its own head office in London, with a receiver-general there or for each county, and under him its head collectors and collectors. Each department had its own rules, based on the Acts of Parliament applying to it, for the remittance of collections to the Head Office, and from there at intervals to the Exchequer.

[1] Francis, Vol. I, pp. 272–5.

Sometimes the maximum balance which an officer or Head Office might have in hand was limited; sometimes the time allowed for remittance of money after collection was fixed. But within these rules officers had complete freedom as to the handling of the money. They were responsible for producing the amount collected in due course, and had to give security for this. Any amount that they could get as interest on the balances whilst they held them was regarded as part of their legitimate remuneration or perquisites. Naturally, therefore, many collectors were apt to delay paying in collections as long as they could without getting into trouble for breaking the regulations.

Several of the seventeenth-century pamphleteers who made proposals for large banks with branches throughout the country pointed out that such a bank could assist greatly in remitting the revenue and cutting down idle balances. Complaints were made that in the time of Charles II receivers lent their balances to the goldsmiths, whilst State creditors who could not get paid had to go to the goldsmiths to borrow.[1] It seems unfortunate that when the Bank was founded no provision was made for its holding public balances. Probably this was due to Parliament's rather strong feeling of jealousy lest the Bank should become too powerful, and to the desire to avoid too close a connection between the Bank and the Government, lest the latter might try to get loans from the Bank without the consent of Parliament.

The remittance of the revenue to London became much simpler, and involved much less expense and tying up of cash, when it became the regular custom to remit by means of inland bills of exchange. This seems to have happened from 1696 on account of the shortage of cash due to the re-coinage.[2]

[1] Foxwell's introduction to Philippovich, pp. 8–10.

[2] Philippovich, pp. 97, 109, 156. The use of inland bills of exchange became common in the seventeenth century; see Feavearyear, pp. 149–50. For arrangements made in 1667 in an attempt to get the Receivers of the Land Tax to remit promptly by means of bills, see Calendar of Treasury Books, 1667–8, pp. 10, 39, 45, 71, 208, 523.

It will be convenient to consider the history of the paymasters' balances in relation to the Bank in the eighteenth century along with that of the receivers' balances, as the course of development was much the same for both. For the civil service most payments were made directly to the final payees at the Exchequer, but for expenditure on the Navy and Army advances were made to paymasters. The system of accounting made it almost inevitable that they should hold considerable cash balances for long periods even after their term of office had ceased. Funds for different heads of service were kept separate, so that it was necessary to keep a balance under each head. The accounts were not closed each year, but payments continued to be made for the service of the year from the funds allotted to that year until all claims were settled. Thus at times payments had to be made from a paymaster's account long after he had left office, and a balance would be kept in hand till his accounts were finally settled after many years.

Paymasters were in the same position as receivers in regard to the profit from the custody of balances. A reasonable profit from a normal balance was regarded as a legitimate reward for the heavy responsibility. But there was a temptation to keep the balances as large as possible in order to increase the profit, and no doubt a paymaster had very much more scope for doing this than any receiver. It is well known that some politicians, such as the elder Fox (Lord Holland), made large fortunes in the eighteenth century by taking undue advantage of a paymaster's opportunities. The elder Pitt (the Earl of Chatham) gained much credit by refusing to make money in this way. Burke and others exposed the evils of the system very thoroughly in 1780, and when Burke became Paymaster-General of the Forces in 1782 that office was placed on a proper footing.

Early in the eighteenth century the Bank actively sought to get the custody of the public balances. Professor Foxwell quotes the following statement in this connection from a pamphlet of 1706: "It has

been said that they [the Bank] would give a million of money for this privilege." [1]

In 1711 the Bank made a formal representation to the Lord High Treasurer (Lord Godolphin) as follows:

> "Since the undertaking by the Directors to make all Exchequer bills specie, they found that some public offices which ought to cultivate a good understanding with the Bank, from the frequent services done them, nevertheless kept their cash with others, and not at the Bank, and that the greatest part of the receivers transacted their affairs in other places. Asked his Lordship to give effectual directions in these affairs."

On this the Lord Treasurer consulted the Commissioners of Taxes (*i.e.* the land tax and house duties), and they replied: "The Commissioners will exhort the receivers, which is all that can be done, since they and their security are answerable for all failures." The Governor and Directors again complained in person in January 1712 "of their ill condition to serve the public, by reason very few of the Receivers, Paymasters, or others having the public money, negotiate their affairs with them." The Lord Treasurer promised "all reasonable assistance," and especially "that in appointing new receivers he will have a special regard to the matter." [2] This clearly applies only to the Receivers of the Land Tax, who paid directly into the Exchequer through their own private agents in London, and not into their Head Office.

The services to public offices mentioned above by the Bank probably refer chiefly to the discounting of tallies for the paymasters, though the Bank had at times to refuse to do this.[3] The Lord Treasurer some-

[1] Introduction to Philippovich, p. 11, note a. The quotation goes on to state that the privilege in question had been "expressly prohibited" by Parliament, which is an error. The writer adds that "some think there are means found out, in a great measure, to evade that prohibition," which perhaps indicates that the special arrangements with the Exchequer, to be described shortly, already existed in 1706.

[2] Calendar of Treasury Papers 1708–14, pp. 333–4.

[3] *Ibid.*, p. 116 (May 1709).

times took part in negotiations between the Bank and the paymasters, as for instance in 1709, when an agreement was made by Sir Henry Furness, Paymaster-General of the Forces, to buy bills on Amsterdam from the Bank and pay with Exchequer Bills. The Treasury minute on this matter ends as follows:

> "Mr. Eyles desires that in regard the Bank are always ready to assist Sir Henry in his affairs for the public service, he should do what in him lies to serve the Bank by keeping his cash there. My Lord says he thinks it very reasonable, and Sir Henry assures his Lordship he will always do so for the future." [1]

Again in 1712 we find the Lord Treasurer requesting the Bank to lend £100,000 to the Treasurer of the Navy "on a deposit of tallies and orders." [2]

From the above quotations it is clear that by about 1710 some of the cash balances of the receipt and issue offices were in the Bank's custody, but the Bank was not satisfied with the position, and was anxious to hold all these balances. The security of the Bank of England would certainly be superior to that of any "private" bank, as the other banks came to be called. Evidently then, the reason why the Bank did not get all these balances, so far as they were held in London, was that they could be lent more profitably elsewhere. It seems probable that the Bank had already adopted the policy of not paying interest on deposits; if it did pay interest, this must certainly have been less than the other banks allowed.

The assistance promised by the Lord Treasurer must have had some effect in inducing officers to place their balances at the Bank. But it is not likely that Sir Henry Furness, for example, interpreted his promise as pledging him to keep the whole of his cash balance there. In about the middle of the century the elder Pitt, as Paymaster-General of the Forces, was keeping part of his cash with the Bank of England and part with

[1] Calendar of Treasury Papers, 1708–14, p. 147. [2] *Ibid.*, p. 334.

other banks. By 1781 the movement of State balances into the Bank had gone so far that we find it spoken of as "the cashier of the public," or even "the public exchequer."[1] It is likely that Burke's great speech on financial reform in February 1780, and the resulting pressure of public opinion, caused a sudden acceleration of the movement.

At any rate, in 1781 the Commissioners on Public Accounts reported that the following kept their cash with the Bank then: the Customs, Excise, Stamp, Post and Salt Offices, the various Receivers of the Land Tax, the Paymaster-General of the Forces, the Treasurer of the Navy and the Treasurer of the Ordnance. This list includes all the most important of the head revenue offices in London, as well as the three great paymasters. The Receivers of the Land Tax in the various counties are specially mentioned because of their direct relations with the Exchequer. They were now remitting their bills to the Bank, instead of to other agents, for collection and payment into the Exchequer in due course, though that did not prevent them from keeping large balances in their own hands and delaying their purchases of bills. The Bank would not, of course, expect to have any direct relations with the receivers throughout the country in the other departments, since they remitted collections to their respective Head Offices.

By 1781, then, the arrangement for which the Bank contended in 1711 seems to have been in full operation. But it was still legally quite possible for any officer to remove his account and the public balance in it from the Bank, and dispose of it elsewhere as he pleased. Burke proposed in 1780 that the Government should negotiate with the Bank and arrange to make the holding of public balances with it compulsory, if, in return for the profits on them, it would meet certain Government expenses for the Mint and for foreign remittances. If satisfactory terms could not be made with the Bank, the Government might try any other reputable banker,

[1] Philippovich, pp. 177–8.

who would be a better security for public money than a paymaster.[1]

Burke's plan was not followed, but in 1783 an Act of Parliament required the Paymaster-General of the Forces to keep his balance at the Bank, and the same arrangement was soon imposed on the other paymasters. Again, in 1806 the chief revenue offices, the Customs, Excise, Stamp and Post Offices, were required by law to pay all their receipts into their respective accounts with the Bank in the name of the Receiver-General of each office, except small amounts within fixed limits which could be retained to meet current expenses.[2] No interest was asked for; the Bank kept the profit on the balances, and set it against the expense of keeping the accounts, according to its usual arrangement with other customers.

The profit on the balance was, however, taken into consideration at various times when other financial arrangements were made between the Government and the Bank. The balances were naturally large during the long wars with France at the end of the eighteenth century. In 1800 the Bank's charter was renewed in return for a loan of £3 millions without interest for six years; Pitt included among the advantages for which the Bank ought to make a return "that of holding the public balances in their possession."[3] A Committee that investigated the charge for managing the National Debt in 1807 took into account the fact that the Bank had "the benefit of holding all the money for half-yearly dividends, besides having the cash for the navy and army service."[4]

We must turn now to consider the Exchequer balances. It seems at first sight strange that all the emphasis in the discussions of the eighteenth century is laid on the balances of the receipt and issue offices. There is no

[1] See Burke's speech of February 11th, 1780, in Cobbett, "Parliamentary History," Vol. 21, pp. 1 ff.

[2] Philippovich, pp. 185–6.

[3] Francis, Vol. I, p. 257.

[4] *Ibid.*, p. 275.

agitation for transfer of the Exchequer balances to the bank. The movement for financial reform from 1780 was much concerned with the Exchequer, but mainly with a view to abolishing sinecures and cutting down the enormous incomes its officials received from the fees on its transactions. The Exchequer balances, in fact, were not a real problem, because they had ceased to be held, as a rule, in current money. The transfers from the revenue office accounts at the Bank to the Exchequer, and from the Exchequer to the accounts of the paymasters at the Bank, were managed without moving actual cash, except for small odd amounts. Thus, in the balances of the receivers-general and the paymasters the Bank held the great bulk of the public cash balances in London. The Exchequer had become practically an office for keeping accounts. The four Tellers' chests contained not coin, but paper entitling them to demand coin from the Bank of England; in practice, cash was not demanded, but current payments for the civil services were made by Bank of England clerks at the Exchequer according to the orders of the Tellers' clerks.

It is by no means easy to describe this peculiar arrangement accurately, or to state with any definiteness how and when it arose. The account given by Professor von Philippovich in his generally excellent work is not altogether satisfactory. The clearest picture of the arrangement in actual working is contained in the evidence given in 1830 before the Commissioners of Revenue Inquiry; a "Report on the Exchequer" based on this evidence was made by the Commissioners of Public Accounts in 1831,[1] and led to the abolition of the Exchequer of Receipt in 1843. Our best course will now be to describe the system as it existed in 1830, and then see what can be said about its development before that time.

The Bank sent three clerks, known as "out-tellers,"

[1] Parliamentary Papers, 1831, Vol. X (313), pp. 3–23 is the Report; the evidence of 1830 is reprinted as App. X to this report, pp. 149–72.

to the Exchequer every working day to carry out receipts and payments for the Tellers of the Exchequer.[1] They would arrive at about 11 a.m., bringing with them in a hackney-coach from the Bank about £100,000 to £150,000 in ordinary current bank-notes up to £1,000 each, and from £150,000 up to sometimes as much as £1 million in special "cancelled" bank-notes of denominations from £10,000 to £100,000. From these cancelled notes the cashier's signature had been torn off, so that the Bank would not pay cash for them, and they were useless except to act as counters in effecting transfers between the Bank and the Exchequer. The Bank's clerks also had a chest under their own lock at the Exchequer, where they left their balance in coin over-night to the amount of £200 or £300.

Payments received by the Bank's clerks at the Exchequer would be either in coin and notes from the public or in cancelled banknotes from the chief revenue offices. Under the Act of 1806 regulating the relations of the revenue offices with the Bank, these offices had to make regular transfers to the Exchequer. This was to be done by giving a "write off" order to the Bank and taking a cancelled bank-note for the amount, which the Bank's clerks at the Exchequer received as cash.

On receiving a payment the Bank's clerk gave one or more tickets as required showing the head of revenue and the amount with his initials, and indicating by a letter on each ticket the Deputy-Teller to whom it related. The person making the payment then took this ticket to the proper Teller's office, paid the fees in cash, and entered details of his payment in the Teller's book, from which the Teller's bill was prepared and thrown down to the Tally Court according to the old procedure.

The payments out of the Exchequer were similarly made by the Bank's clerks. After the order for payment had been duly passed in the Exchequer, a clerk in the Teller's office concerned would write a ticket with the

[1] Parliamentary Papers, 1831, Vol. X (313), p. 81.

amount and the payee's name, but no signature; this was taken by the payee to the Bank's clerks in another room, where he received payment. The Bank of England clerk, who gave evidence in 1830 after doing this work for over thirty years, said that the handwriting of all the Tellers' clerks was known to him, and that no mistake or fraud had ever occurred. He stated that this practice had existed for many years before 1800. Formerly verbal directions had been sent by a money-porter for each payment.

The procedure for payments to the paymasters who received credit on the books of the Bank was described by the same clerk as follows:

> "A gentleman from the Army Pay-office brings an order directed up to the Bank department, and there I am prepared with a receipt, which I fill up agreeably to the amount directed upon the order, and therefore I am in possession of the amount of the ticket that he must give to me; then he takes the order and receipt to the Teller, and brings back a ticket, and upon the receipt of that ticket I give the Army credit in the account of the Bank." [1]

The Exchequer closed at about one o'clock, unless payments were needed after that for the public service. The accounts were then made up between the Bank's clerks and each Teller's office. Each ticket for an amount received represented cash due from the Bank's clerks to a Teller, whilst each ticket for an amount paid out represented cash due from a Teller. The balance for each Teller was then paid over or received, normally in bank-notes as far as possible, though Exchequer bills might be used for payment to the Bank in some cases, and coin would be necessary for small balances. The parcels of bank-notes were made up and labelled by the Bank's clerks, and it appears that the Exchequer officers were usually content to check the total from the labels without examining or counting the notes. As the cancelled bank-notes were used in these transfers

[1] Parliamentary Papers, 1831, Vol. X (313), p. 165.

except for amounts under £10,000, the following comment by an Exchequer official is very apt:

> "The greater portion of the monies locked up, or deposited in the Tellers' Chests, are mere memoranda between the Bank and the Tellers and are peculiar notes, which would not pass current." [1]

After settling accounts thus at the Exchequer, the Bank's clerks returned to the Bank, delivered the notes they had brought back to the Chief Cashier, and gave details of the accounts to the various departments concerned.

In giving joint evidence in 1830, two of the Deputy-Tellers stated that "from the mode in which we do business with the Bank of England we cannot commence till the arrival of the Bank clerks." [2] In a written statement, all four Deputy-Tellers defined the duties of the Bank's clerks as follows: [3]

> (1) "To receive, examine and exchange the Bank paper presented at the Exchequer; on which account they have for many years past, since the use of Bank-notes has become so universal, been made the medium of all the Tellers' receipts and payments to individuals."
>
> (2) Under the Act of 1806 to receive the cancelled notes from the Receivers-General of the Revenue Offices and give credit for them with the Tellers.
>
> (3) To receive all issues for the Army, Navy, Ordnance, etc., and "credit . . . the same in their respective accounts with the Bank."
>
> (4) "To receive from the Tellers the Exchequer bills upon which the Bank has agreed to make advances to the public, and to pay the amount of them, according to the directions of the Auditor."

Another account of the working of this system is available in the evidence of the Chief Cashier of the Bank in 1797 before the Committee of Secrecy of the House of Lords inquiring into the Bank's advances to

[1] Parliamentary Papers, 1831, Vol. X (313), p. 40.
[2] *Ibid.*, p. 168. [3] *Ibid.*, p. 81.

the Government.[1] It is not very clearly expressed, but the arrangements seem to have been identical with those of 1830, except that transfers between the Bank's clerks and the Tellers were made by Exchequer bills for £1,000 each. Probably the cancelled bank-notes did not come into use till after the Act of 1806.

Special Exchequer bills for £5,000, and not exceeding fifty in number, to be "current only as payments between the Exchequer and the Bank of England," were ordered to be issued in 1710.[2] Whether these were used in the same way as in 1797 is not clear, but at any rate they indicate that some special arrangements between the Bank and the Exchequer of Receipt were already in existence.

The Deputy-Tellers stated in 1830 that "for nearly a century past, the Bank of England has sent down to the Exchequer persons duly authorised to examine and receive its own notes."[3] This statement has been frequently repeated without noticing that the time mentioned is very much an under-estimate. A list of the establishment of the Bank as it stood in November 1695 was published by Francis in 1848, and it shows two clerks under the head "Exchequer."[4] One of these two, J. Malbon or Malborne, was evidently specialising in Exchequer business already in December 1694, when the Court ordered him to check all the tallies for payment of the loan of £1,200,000 into the Exchequer. He was one of the employees appointed when the Bank opened in July 1694, so that it seems likely that he began to attend the Exchequer regularly almost at once. An establishment list of August 1697 shows two persons deputed "to attend the Exchequer."

[1] Journals of the House of Lords, Vol. XLI, p. 206.

[2] 9 Anne, c. 7, quoted by Philippovich, pp. 106, 180.

[3] Parliamentary Papers, *loc. cit.*, p. 66.

[4] Francis, Vol. II, p. 258. The list purports to be that "at the first establishment," which has misled several writers. It is greatly expanded from the original establishment, now available from the Court Minute Books in Richards, p. 152. Evidently the staff and salaries were regarded as on an experimental basis till November 1695.

By 1700 the number had increased to three, at which it probably remained for the whole time till the Exchequer account was transferred to the Bank in 1834.[1]

No doubt the duties of these clerks included presenting for encashment tallies that the Bank had discounted, but this would hardly be whole-time work for them. It cannot be doubted that from the first they also performed some functions connected with Bank bills presented by the public for payment at the Exchequer. We have seen that in 1694 the Exchequer received the greater part of the Bank's permanent loan of £1,200,000 in the Bank's bills and notes, and used them for payments to the public.[2] It could hardly then refuse to take them from the public. The Bank of England clerks who were attending at the Exchequer in 1695 presumably certified the genuineness of the Bank's paper money, when it was received in payments at the Exchequer.

Difficulties must have arisen about receiving Bank bills at the Exchequer when they went to a discount in 1696–7, as already related. This was almost certainly one of the reasons for the passing in 1697 of the "Act for the better observance of the course anciently used in the receipt of the Exchequer" (8 and 9 Will. III, c. 28). This Act provided that money should be received by weight and tale according to the ancient course, and no Teller's bill should be written unless the money were actually received or payment orders for the amount surrendered. A special proviso allowed paying and receiving by Exchequer bills to continue as before.[3]

It would be very interesting to know precisely what

[1] Richards, pp. 149 (note 7), 152 and 155. Dr. Richards seems to have missed the significance of these facts completely, as he states, on p. 138, that there was "hardly any change in the Exchequer methods of the receipt and issue of public revenue" from 1688 to 1834.

[2] Cf. Feavearyear, p. 116. These Bank bills, which it received in 1694, "the Government paid out in all parts of the country for supplies for the army, and soon they were accepted at par in payment everywhere."

[3] Statutes at Large, Vol. X, pp. 99 and 104.

was done about Bank bills tendered at the Exchequer, whilst they were at a discount in 1696–7 through the partial suspension of cash payments by the Bank, both before and after the Act of 1697. My conjecture is that the Bank's clerks may have taken down Exchequer bills and given them in exchange for Bank bills to persons desiring to make payments. There were Bank bills in the Exchequer of Receipt in December 1696, and a special order was given by the Treasury to issue them all at once to the Army Paymaster.[1] Possibly these were received before they went to a discount, and the loss on them may have led to the Act of 1697, which clearly ruled out the Bank's paper for payments at the Exchequer.

The fact that Government officers accepted Bank bills freely till they went to a discount, and then began to refuse them, appears from petitions to the Treasury in July and August 1696 asking that customs officers be directed to receive customs duties in Bank bills. This was refused, but in November 1696 the Treasury ruled that certain payments between Government offices might be made in Bank bills.[2]

The inability to receive Bank bills at the Exchequer was obviously inconvenient, for in June 1698, when they had been at par again for some time, the Treasury took action to obtain a temporary suspension of "the law requiring all payments to be made in the Exchequer in Specie."[3] By an Act of Parliament, 9 and 10 Will. III, c. 44, section 89, the Treasury was given discretion till the end of the next session of Parliament to permit the Tellers of the Exchequer to receive sealed bills of the Bank of England instead of cash in all payments, but they were not to be taken at a discount.[4]

[1] Richards, p. 178.

[2] Calendar of Treasury Books, Vol. XI, p. 48, and Calendar of Treasury Papers, 1556–1696, pp. 531, 556.

[3] Calendar of State Papers, Domestic, 1698, pp. 308, 315.

[4] Statutes at Large, Vol. X, pp. 229–30. Cf. Commons' Journals for June 18th, 22nd and 23rd, 1698 (pp. 319, 327, 328).

In 1699, by another Act, 10 and 11 Will. III, c. 22, section 14, this provision was extended to the end of the next session of Parliament.[1] I have not been able to trace any further extension, but it can hardly be doubted that the Exchequer accepted Bank of England bills and notes continuously from 1698 without any further break. Probably their position as the equivalent of cash had become so thoroughly established and unquestioned by 1700, that it was not thought necessary to renew the formal permission to accept them at the Exchequer, and the specie law of 1697 was thenceforth tacitly ignored. In the enquiries of 1830–31 no one suggested that there was any Parliamentary authority overriding the specie provision in the 1697 Act; the receipt of Bank paper as cash was put solely on the ground of a long-existing custom.

The Deputy-Tellers in 1830, as already mentioned, attributed the system of receipts and payments through Bank clerks to the fact that "the use of Bank-notes has become so universal." If it goes back as far as the latter fact, it must certainly date from the end of the seventeenth century, as the use of Bank bills was then already very widespread.[2] Since the Bank's clerks were in regular attendance at the Exchequer at least from 1695, and Bank bills were accepted continuously at the Exchequer from 1698, it would probably not take long for the further development to occur. I believe that it existed by 1699, and that it was probably for this reason that the number of Bank clerks attending the Exchequer was increased from two to three between 1697 and 1700. There is a minute of the Court of Directors of the Bank of England dated 10th May, 1699, stating that the tellers of the Exchequer of Receipt were forbidden from that date to receive any goldsmiths' notes "among the money they received from the Bank."[3] This seems to me to refer to the Tellers (a special class

[1] Statutes at Large, Vol. X, pp. 286–7.
[2] Philippovich, p. 178; Feavearyear, p. 116; Richards, pp. 48–9, 236.
[3] Richards, p. 172.

of clerk) whom the Bank deputed to work at the Exchequer, and to the money taken by them from the Bank to make payments on behalf of the Exchequer.

The close association between the Bank's Tellers and the Exchequer at this time is illustrated by the fact that they assisted the Exchequer staff in telling the new money in the Mint at the time of the re-coinage of 1696–9.[1]

Thus it seems that the special relations between the Bank and the Exchequer described above as existing in 1830 were probably already much the same at the end of the seventeenth century. The practice of making transfers between the Exchequer and the Bank's clerks in Exchequer bills would, then, have developed some time before 1710; the creation of the special Exchequer bills of large denomination in that year to be used in such transfers was presumably merely intended to make an existing practice more convenient. If all this is correct, Professor von Philippovich was perhaps wrong in thinking that the carrying out of public monetary transactions by the Bank arose first from its connection "not with the Exchequer, but with the receipt and issue offices."[2] It is true that the Bank in 1694–6 advanced large amounts for remittance abroad for the war on the security of tallies deposited by the Army Paymaster.[3] But anything approaching the regular performance of banking functions by the Bank for any of the receipt or issue offices probably came later than the special arrangement by which transactions were carried out on behalf of the Exchequer.

However that may be, we must pass now to the reform of 1834, by which the "Public Deposits" at the Bank were organised along lines which in principle remain the same to-day. The Exchequer of Receipt with its "ancient course" disappeared, as recommended by the Commission of 1831. The Act of 1834 (4 Will. IV,

[1] Calendar of Treasury Papers, 1697–1702, p. 493. The Treasury refused to pay the Bank tellers for doing this.

[2] Philippovich, p. 176.

[3] Richards, pp. 183–7.

c. 15) placed the Bank in the position of the four Tellers of the Exchequer under the old system. It was to keep an account, known as "the account of His Majesty's Exchequer," representing the general public balances formerly kept in the Tellers' chests.

The Bank also continued to keep accounts for the chief revenue offices, from which transfers were made periodically to the Exchequer Account. Issues from the latter to the accounts of the paymasters and other "public accountants" authorised to hold public accounts at the Bank could be made only by the direction of a new officer, known as the Comptroller-General of H.M.'s Exchequer. His orders were given on receiving a Treasury warrant and checking the legal authority for the issue. Fresh officers, known as the Paymaster of the Civil Services and the Paymaster of Exchequer Bills, were appointed to make the final payments to State creditors hitherto made at the Exchequer of Receipt through the Bank's clerks.

A further reform was the consolidation of the various Pay offices into the single office of the Paymaster-General by 1848. This made possible the holding of a single balance for a number of purposes for which separate accounts had formerly been kept, and effected an economy of balances. The Comptroller-General objected to this change, on the ground that it lessened the usefulness of his check on issues, and made it possible to apply money for purposes other than those for which it was granted.

Finally it had to be recognised that the Comptroller-General's control of issues could only operate to keep the total issues within the limits authorised by Parliament. The check as to the application of the money to the proper purposes could only take place after the expenditure by means of the "appropriation audit," which began with the Navy accounts in 1832 and gradually extended its sphere to all Departments.[1] In 1866, by the Exchequer and Audit Departments Act, the two Departments were amalgamated under a single head, the Comptroller and Auditor-General.

[1] Philippovich, p. 200.

From 1833 till 1844 the Bank sent weekly returns to the Chancellor of the Exchequer, which were published monthly in the form only of an average over the previous three months. This contained four separate figures under "Public Deposits," namely (1) "Exchequer Accounts," (2) "For Payment of Dividends," (3) "Savings Banks, etc.," and (4) "Other Public Accounts."[1] But since the Bank Act of 1844 the published weekly return has given only a single figure for "Public Deposits," with a note that it includes "Exchequer, Savings Banks, Commissioners of National Debt and Dividend Accounts." Bagehot objected strongly in 1873 to the inclusion in "Public Deposits" of the balances of the Secretary of State for India in Council, as these might fluctuate independently in a quite unforeseeable manner.[2] This has since been rectified, and the figure for "Public Deposits" now includes only money held in one way or another for the British Government.[3]

It is not necessary to describe here in detail the mode of operating the public accounts at the Bank. The next chapter will contain an account of the arrangements now in force.

By the end of the eighteenth century the Bank's relation to Government borrowing and the public balances had become fairly fully developed. In the Parliamentary inquiries of 1857–8 the idea of a "National (*i.e.* State) Bank," as suggested by Ricardo, to control the note-issue and handle the Government's banking business, attracted some attention, but received no real encouragement. Practically in the nineteenth century there was no inclination to change the existing relations between the Government and the Bank in the fields of borrowing and balances except in matters of detail. The interesting

[1] Andréadès, p. 291.

[2] Bagehot, "Lombard Street," new edition, 1919, pp. 287–88.

[3] In 1913 it was stated that "for many years now" the India Council's balance at the Bank of England had been included not in the "Public Deposits," but in the "Other Deposits." J. M. Keynes, "Indian Currency and Finance," 1913, p. 129.

development in the nineteenth century was the growth of the idea and technique of "credit control," and the question arose as to what part, if any, the Government should take in this. A long series of Parliamentary Committees in 1797, 1810, 1819, 1832, 1840, 1847 and 1857 made inquiries bearing on the matter, and volumes could be written about it. Here it must be dealt with very summarily.

In 1763 began that series of periodic crises in business which seem to arise from what Mr. Hawtrey calls the "inherent instability of credit." It is claimed that in the period 1763–97 the Bank, led by Samuel Bosanquet, began to discover the principles of credit control. Henry Thornton, in his work on "Paper Credit" in 1802, was the first to point out how the discount rate could be used to control credit, and to show that the limitation of the rate of interest to five per cent. under the Usury Laws prevented the Bank from making proper use of it.[1] During the Bank Restriction period, 1797–1821, the country's business was carried on with inconvertible bank-notes; no progress was made with credit control, because there was no clear penalty for the over-issue of notes, and the Directors had no hesitation in discounting all good commercial bills at the fixed rate of five per cent.

Some writers have blamed Pitt severely for the suspension of cash payments in 1797,[2] as the Bank Directors did at the time. The Directors repeatedly protested against the amount of advances to the Government outstanding in 1796, and especially the excess over £500,000 in the advances on Treasury Bills.[3] But it has been shown

[1] Feavearyear, pp. 161, 227–8. [2] *E.g.* Andréadès, pp. 190–4.

[3] These Treasury Bills were drawn by Government officers and sold abroad, and the Bank was expected to advance money to meet them on presentation. The practice arose during the American War, 1775–83 (see Acres, "The Bank of England from Within," Vol. I, p. 265, and Hawtrey, "Currency and Credit," p. 321). S. Bosanquet in 1797 said the custom had existed "time out of mind" (Journals of the House of Lords, Vol. XLI, p. 196), and this slip has often been repeated. Philippovich (p. 180) quotes this phrase as applying to the Bank's relations with the Exchequer, a completely different point.

that the advances were not in fact excessive, and that the real difficulty was an external drain of gold from 1795 due to the premium on it in Paris, together with the internal drain in 1797 caused by fear of an invasion.[1] Ricardo's view that the crisis of 1797 was not due to the Bank's advances to the Government was correct.[2]

The famous Report of the Bullion Committee in 1810, and the controversy that succeeded it, need not delay us long. The Committee were obviously right in pointing out that bank-notes had depreciated, and that the Directors had extended commercial discounts unduly. But such plain speaking is not tactful in the middle of a national struggle for existence! It is clear to us now that cash payments could not have been maintained all through the Wars of 1793–1815, and that to propose a resumption of cash payments whilst the country was still at war was absurd. The most sensible attitude was that of Canning, who admitted the truth of the Committee's diagnosis, but voted with the Government against their proposals.

Ricardo pointed out that during the Restriction period the Bank "lent money below the market rate of interest."[3] It is not possible to blame the Bank for strictly obeying the law as to the maximum rate of interest (five per cent. since 1713). But since, by various devices, business was generally done at a higher rate, and the Government itself was paying more by selling its War loans at a discount, it is no wonder that there was great eagerness to borrow from the Bank. The true remedy, of course, was the removal of the upward limit on the discount rate. This was not likely to come till the Bank authorities definitely wanted it. At the end of the Restriction period they had no desire at all to be held responsible for the general control of credit or currency; in 1819 the Court as a whole passed a resolution denying that its policy could affect the exchanges, though most of the individual Directors who appeared before the Com-

[1] Hawtrey, "Currency and Credit," pp. 322–30.

[2] Ricardo, "Principles of Political Economy," ed. Gonner, 1929, p. 346.

[3] *Ibid.*, p. 352.

mittee of 1819 admitted that a reduction of the note circulation should improve the exchanges.[1]

The change in the general position of the Bank in the course of the nineteenth century is very well illustrated by the different ways in which its extra profits were handled in the two Great War periods 1793-1815 and 1914-18. During the Restriction period enlarged dividends and bonuses were distributed on a generous scale, but after the last Great War the extra profits were voluntarily surrendered to the State.

Up to about 1825 the Bank definitely aimed at high profits for its Proprietors, and resented any imputation of public responsibility, except to keep itself in a sound position and to give a preference to the Government in making its advances. It was not willing to give more than a minimum of information about its affairs even to Parliamentary committees; this attitude was considered correct, and the committees were not inclined to force the Bank to make unwilling disclosures. It has been said that

> "when appearing before Parliamentary committees the Directors showed a strong tendency to answer very curtly the question put, to volunteer no information and to take refuge in ignorance when asked anything regarding the relationship between the management of the Bank and the general control of credit." [2]

At the same time, it must be admitted that the Directors were wise enough to withstand the desire, very pertinaciously expressed by some of the Proprietors, for maximum dividends and the distribution of all available profits. The Directors gave no statement of accounts to the Proprietors till 1832, though suits were brought by some malcontents in the attempt to compel them to do so. The refusal was partly due to the Directors' policy of maintaining a reserve of undistributed profits. There was considerable opposition to this policy at times among the Proprietors, and the rendering of accounts might have helped the opposition. By

[1] Feavearyear, pp. 205, 207, 212. [2] *Ibid.*, p. 229.

1819 the Proprietors' ideas were becoming sounder, for the disclosure, through Peel's Committee of that year, that the undistributed profits were over £5 millions, did not provoke much agitation for higher dividends.[1]

The gradual insistence on giving publicity to the Bank's accounts marks a growing recognition of its special position and public responsibility, in the general control of the national currency and credit. The Act of 1819 required the weekly average of notes in circulation to be sent to the Privy Council, and a similar quarterly figure to be published in the *London Gazette*.[2] From 1833 weekly returns giving all the important figures in some detail were sent to the Chancellor of the Exchequer, but only quarterly averages were published each month in the *London Gazette*. The familiar published weekly return under a few important heads was made available to the public by the Act of 1844, and remained practically unchanged till 1928. The Bank was not anxious to volunteer more information than it was obliged to give. In 1877 it ceased to give a figure for "bankers' deposits" as distinct from the rest of the private deposits.[3] This figure was not published again till 1928, when the Currency and Bank-notes Act gave power to the Treasury, in agreement with the Bank, to make improvements in the form of the weekly return.

After 1819 a more intellectual school of Bank Directors, men who understood the theories of Thornton and Ricardo about paper money, discount-rates, price-levels and gold-flows, began gradually to get control. Of these J. H. Palmer and S. Ward were the most important. By 1827 they were strong enough to get the Directors to rescind the resolution of 1819 denying the Bank's power to influence the foreign exchanges through its issues of notes.

Meanwhile, in 1825, a serious credit crisis had occurred. The Bank failed to raise the discount rate in time from four per cent. to the maximum of five per cent., and also made

[1] Acres, Vol. I, pp. 284–6, 319–21. [2] *Ibid.*, p. 317.
[3] Andréadès, pp. 262, 290–1, 324.

matters worse for some time by a vacillating policy as to advances. The Directors were looking to the Government for another restriction of cash payments, or for an issue of Exchequer bills to merchants against goods, as in 1793 and 1811. But the Government insisted that the Bank must itself make the necessary advances and pay out gold as long as it lasted. The use of some small notes dating from 1818, together with a vigorous policy of lending in new ways, first against Government securities and then against goods, carried the Bank safely into calmer waters.[1]

It was generally agreed that the over-issue of notes by the country bankers was the root of the trouble in 1825. The remedies applied by Parliament were: (1) the prohibition of small notes under £5, (2) relaxation of the Bank's monopoly (which forbade the issue of notes by other joint stock banks), by permitting joint stock banks of issue outside the area within sixty-five miles from London, and (3) authorising the establishment of branches by the Bank of England.

The Government had formerly urged the Bank to agree to start branches, but the Bank had never been willing to do so till 1826.[2] Eleven branches were opened in the principal provincial cities of England by 1827, and in 1834 two more were opened to facilitate Government payments for the Navy. The Law Courts Branch in London was opened in 1881 at the suggestion of the Treasury.[3] The total number of branches has never been much over a dozen, and has tended to decrease recently. The country bankers much resented their competition, though they found it useful to be able to remit funds through them. They were very useful for the remittance of Government revenues, and, at the request of the Government, they arranged to send out clerks to receive the collections from tax collectors

[1] Report of the Committee of 1832 (Parliamentary Paper 722 of 1831–2): evidence of Palmer, Harman and Ricardo, and Appendix 4. Hawtrey, "Art of Central Banking," pp. 121–22.

[2] Report of 1832, pp. 35, 163–4.

[3] Acres, pp. 433–6, 543–4.

at various points. Country bankers' notes were only accepted at Government risk and to a limited extent, which caused some friction and jealousy.[1]

J. Horsley Palmer became Governor of the Bank in 1830, and was undoubtedly the first Governor to have a real understanding of the Bank's special responsibilities and a reasoned plan for discharging them. His evidence in 1832 shows that he had a very clear idea of the use of Bank-rate changes to affect prices, and so also the foreign exchanges and the flow of bullion. He also clearly expressed the modern idea that the Bank should not compete for discount business at ordinary times, but should keep its rate above the market rate and discount freely at that higher rate in times of pressure. This view arose from the circumstances of the previous decade, when the Bank maintained its traditional minimum rate of four per cent. whilst the market rate went lower. Thus the Bank had little discount business, and had to use its funds in investments.[2]

The Bank Charter Act of 1833, passed after the investigation of 1832, was a most important measure of reform; it deserves to rank with the major Acts passed by the Reform Government that came into office in 1832. Bills of exchange and promissory notes with not more than three months to run were exempted from the operations of the Usury Laws. Thus the Bank became free for the first time to change its discount rate to the full extent that the situation might require. Moreover, the Bank's notes were made legal tender in payments above £5 (except by the Bank), with a view to reducing the internal drain of gold at times of panic. Joint Stock Banks were now authorised in the area around London provided they did not issue notes. This opened the way to an improvement and consolidation of commercial banking throughout the whole country. As already mentioned, this Act first established a reasonable degree of publicity in regard to the Bank's accounts.

Mr. Hawtrey is of the opinion that the theory of Bank-

[1] Report of 1932, pp. 41–2, 73–4. [2] Feavearyear, pp. 231–2.

rate remained essentially the same in the Cunliffe Committee's report of 1918 as in Palmer's evidence of 1832, and that the instruments of credit and their practical application are still much the same as in Palmer's day.[1] "Open-market operations," of course, had not clearly appeared as an instrument of policy by 1832, but it is interesting to find that they can be definitely traced in the form of "borrowing on Consols" (*i.e.* selling securities and buying an equal quantity to be paid for at the next settlement) in Palmer's evidence before the Committee of 1848.[2]

In spite, however, of the great advance in credit theory made by the Bank under Palmer's leadership, its practical policy for credit control did not work satisfactorily in the next crisis of 1839. The aim was to have a gold reserve of one-third against the total liabilities in normal times, and to keep the total amount of securities constant. Thus a withdrawal of gold would involve a reduction in the total of the Bank's notes plus deposits, and the export of gold should have an automatic effect according to Ricardian theory. It was thought that at a time of pressure the Bank could sell Government securities and use the proceeds in discounting bills. This proved to be impossible in 1839. The Bank had to learn from experience that, to satisfy its function as the ultimate holder of reserves and lender of funds, it must necessarily increase its liabilities in a crisis by extra discounting, and that the Bank-rate must be raised sufficiently to keep the increase within limits.

The unsatisfactory handling of the 1839 crisis opened the way for Peel's well-known Bank Charter Act of 1844; this is usually regarded as the most important banking legislation of the century, though the Act of 1833 has perhaps a better claim to that title. The strict limitation of the note issues of the other banks was no doubt a desirable step, but it is hard to see any great merit in the arrangements applied to the Bank of England notes.

[1] Hawtrey, "Art of Central Banking," pp. 144, 188–9.

[2] *Ibid.*, p. 151.

The separation of the Issue Department, with a fixed fiduciary issue against securities and one hundred per cent. gold backing for all further notes, represented the triumph of the "Currency School." Their assumption that, if bank-notes were strictly controlled, bank deposits could be left to look after themselves, was a mistake due to the fact that notes had been of such preponderant importance in the Restriction period. On the other hand, the "Banking School" was wrong in asserting that notes could never be over-issued as long as convertibility was maintained. The one member of this school, James Wilson, whose views seem to have been thoroughly sound, since he saw that proper use of the Bank-rate was quite indispensable, unfortunately did not publish his contribution till after the Act was passed.[1]

Peel thought that his Act ensured that no serious credit crisis would occur again. It is a pity that he did not adopt proposals made to him for a special provision allowing an additional temporary issue under special conditions when Bank-rate should reach a certain height.[2] For want of this the Government had to issue "crisis letters" in 1847, 1857, 1866 and 1914 promising to ask Parliament to pass an Act of Indemnity if the Bank should find it necessary to break the law. No extra notes were actually paid out under the authority of these letters except in 1857. The fact that the letter had been sent was generally enough to end the panic, since advances could be obtained freely at the Bank on good security; the resulting deposits were just as effective as notes in making payments.

The most unfortunate thing about the Act of 1844 was that it encouraged the Bank to believe that nothing was now needed in the way of credit control beyond the ordinary prudence required in the banking business. Even in 1873 one of the Directors still stated with approval that

> "it was most clearly laid down by Sir Robert Peel in 1844 that it was the duty of the Bank of England to conduct its Banking

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[1] Feavearyear, pp. 251, 252. [2] *Ibid.*, pp. 257–8.

business on the same principles as those adopted by any other Banking establishment in England."[1]

In pursuance of this principle, the Bank at once abandoned the long tradition of not lowering Bank-rate below four per cent. It was reduced to two and a half per cent.; the Bank competed for bills in the market, and greatly expanded its discounts. When pressure arose in 1847, the Bank could give only limited relief, as its reserve was low. It did not take action to protect the reserve promptly by raising the Bank-rate, as it was supposed that the automatic action of the Act of 1844 on the circulation would meet the situation. Peel blamed the Bank for not raising its rate earlier to curb speculation, and thus admitted that the Act of 1844 was not in practice adequate to control credit.[2]

The report of the Committee of the House of Commons on Commercial Distress (1847–8) clearly asserted that the Bank had a special public responsibility in the conduct of its banking business and described it as follows:

"The Bank is a public institution, possessed of special and exclusive privileges, standing in a peculiar relation to the Government and exercising, from the magnitude of its resources, great influence over the general mercantile and monetary transactions of the country. These circumstances impose upon the Bank the duty of a consideration of the public interest, not indeed enacted or defined by law, but which Parliament in its various transactions with the Bank has always recognised and which the Bank has never disclaimed."

It was also stated that the Governor and Deputy Governor did not regard the Act of 1844 as leaving the Bank free to consult only "the pecuniary interests of its Proprietors." [3]

Probably this view would, as a rule, have commanded the assent of a majority of the Directors at any time after 1847. But there was still an influential section led by

[1] T. Hankey, "Principles of Banking," Preface to 2nd edition, 1873, p. viii.

[2] Feavearyear, p. 265.

[3] Parliamentary Papers, Vol. VIII, Part I (395), 1848, p. iv.

T. Hankey which down to 1873 maintained that the Directors were responsible only to the Proprietors, and should run the Banking Department on the same lines as any other bank. The publication of "Lombard Street" by Walter Bagehot in 1873 finally disposed of this view; it brought about the universal recognition of the Bank's special position and public responsibility as holder of the ultimate reserve of the London money market, and hence also as "lender of last resort," to use Mr. Hawtrey's phrase. The position since that date is well described by Dr. Feavearyear:

> "The Bank has never made any public acknowledgment of its responsibilities, but it has never since that time denied them and it has always done its utmost to fulfil them." [1]

After 1847 the Bank regularly raised its rate in order to protect or increase its reserve when necessary. But in normal times Bank-rate followed the market rate, and the Bank was anxious to retain some discount business to avoid a fall in its profits. The crisis of 1857 showed the need for taking action in good time to control dangerous tendencies, and from that time the Bank more frequently put its Bank-rate above the market-rate and sacrificed profits and discount business. But neither the crisis of 1857, nor that of 1866, brought about its withdrawal from the bill market in normal times, as advocated by Palmer. It was not until 1878 that the solution was found in a modification of Palmer's policy which was satisfactory to all concerned. The Bank announced that it would discount for its own regular customers at the market rate. This naturally would be only to a limited amount not liable to fluctuate greatly. For the bill brokers and the market generally the Bank would discount only at the Bank-rate, which would stand above the market-rate. Thus the Bank would always be available for emergency lending on good security, but only at a rate "above the market." [2]

In practice the Joint Stock Banks have never re-

[1] Feavearyear, p. 285. [2] *Ibid.*, pp. 276, 282–3.

discounted with the Bank of England; this is, no doubt, a relic of their original hostility, and it is significant that in 1839 the Bank refused all bills bearing the name of a Joint Stock Bank.[1] The Joint Stock Banks call money from the bill-brokers when they need funds, and thus "force the market into the Bank." The bill-brokers, however, more commonly take advances from the Bank on security at one-half per cent. above Bank-rate for a minimum of seven days, instead of re-discounting bills. As long ago as 1829 the Bank began to make regular "quarterly advances" on securities towards the end of each quarter, when tax money was being accumulated by the Government with a view to payment of dividends; this would remedy tightness in the money market, and even out the flow of funds.[2]

Thus by 1878 the Bank of England was fully established as the Central Bank of Great Britain, with a technique of credit control that on the whole worked smoothly and satisfactorily down to the world catastrophe of 1914. To this control legislation contributed nothing except the Act of 1844, and this gradually decreased in importance as notes became merely the small change of credit. Periodical inquiries by Parliamentary Committees had helped the Bank to systematise its theories and practice, without attempting to give detailed guidance. It was established that the Bank was responsible to the public for its general policy, and definitely was not a mere profit-making private corporation. But it was responsible to Parliament and the nation, and not to the Government. From 1797 it was customary, if things went wrong, for Parliament to appoint a Committee to examine the representatives of the Bank and consider whether any changes were needed.

The Bank's relation with the Government was one of continuous friendly consultation and co-operation. Any advice the Government might give would always receive

[1] Feavearyear, p. 237.

[2] Committee of 1832, Q. 5437, and Gregory, "Select Statutes, etc.," Vol. I, p. xi.

most careful consideration, but in the last resort there was no means of compelling the Bank to accept it, short of asking Parliament for fresh legislation. No difficulties arose in this halcyon period of 1878–1914 to make it necessary to think seriously of changing the existing machinery and relations.

CHAPTER III

THE UNITED KINGDOM, (*b*) THE WAR AND AFTER

THE imminent prospect of a European War in the last week of July 1914 caused a slowing down of the whole delicate international credit machine with its centre at London, and the complete collapse of some important parts. The London Stock Exchange was closed because of the flood of selling orders from the Continent. The foreign exchange markets collapsed for a time because of the pressure in foreign countries to remit to London and the lack of new sterling bills. Thus the commercial banks in London found most of their assets frozen, whilst there was to some small extent a run on them for cash, which was encouraged by their unwillingness to pay out gold. Evidently this was a crisis of quite a different nature from those of 1847, 1857 and 1866, which were adequately met by the Government's "crisis letter," telling the Bank of England to break the Bank Act of 1844 if necessary.

Mr. Hartley Withers asserts that "bankers had long ago represented to the powers that be, that a store of emergency currency would be needed if England were involved in a great war" and that a supply of one-pound and ten-shilling notes ought to have been kept ready. It appears that, just before the crisis, an unofficial committee of bankers submitted to the Government a scheme for amending the Act of 1844, so as to permit the issue of more notes in an emergency, but the Bank of England strongly opposed it.[1] If this account is correct and the Bank of England authorities did strongly oppose such

[1] H. Withers, "War and Lombard Street," 1917 ed., pp. 13, 32.

proposals, they seem to have shown a lack of foresight which there was soon much cause to regret.

The Bank made advances of about £27 millions to bill-brokers and others in the week ending Saturday, August 1st, 1914, leaving it with a reserve of only about £11 millions in the Banking Department. On the morning of that day it abandoned temporarily its duty as "lender of last resort," by refusing to make advances to bill-brokers, whose loans from other banks were being called. This policy was reversed the same morning, and the Bank resumed its usual practice of lending freely on good security.[1] It is hard to see any reason for the temporary refusal, unless the Government was making some difficulty about sending the usual "crisis letter." Bank-rate was put up to ten per cent. that day, and the "crisis letter" was asked for and received the same evening. Rumour had it that the Treasury insisted on having a ten per cent. Bank-rate, as in previous crises, though it could do no good under the special circumstances and only caused unnecessary alarm.[2]

In such a grave and unprecedented situation the Government found it essential to assume the final responsibility and initiate drastic new measures by special legislation. After August 1st, as war became certain, vigorous action was taken. The Bank Holiday on August 3rd was extended for three more days. Meanwhile a moratorium was declared for a month from August 4th for most private obligations. The commercial banks used this to limit payments on cheques to what they considered reasonable. They did not take advantage of the subsequent extensions for two more months, and, in view of the arrangements that were made for supplying them with legal-tender currency, it would seem that the moratorium need never have been applied to the banks at all. From August 8th the Bank-rate stood at five per cent.

The Currency and Bank Notes Act, 1914, passed on

[1] Greengrass, "The Discount Market in London," p. 12.
[2] Withers, *op. cit.*, p. 12.

August 6th, provided for an issue of one-pound and ten-shilling currency notes by the Treasury. Power was also given to the Bank of England to increase its fiduciary issue with the consent of the Treasury. Postal orders were temporarily made legal tender, as there was a stock on hand to the value of £2 millions.[1]

There is no apparent reason why currency notes should have been issued by the Treasury, instead of having small notes issued by the Bank of England, as was done in the Restriction period of 1797–1821. It would probably have been quicker, and certainly simpler, to let the Bank prepare the notes. In any case, they were issued through the Bank, and were theoretically convertible into gold at the Bank, though in practice, as a matter of patriotic duty, gold was not demanded. When the banks reopened they had supplies of currency notes, received in the form of loans from the Treasury at Bank-rate. The Bank of England fiduciary issue was increased by about £3 millions for a couple of days, until further supplies of currency notes were available; this was done legally under the new Act, and not under the authority of the "crisis letter."[2]

When the banks found there was no run for cash after the reopening, they repaid the Treasury loans by transferring credits from their balances at the Bank. The function of the currency notes was now to replace gold in circulation, and with the help of strenuous propaganda this was successfully accomplished. But they were issued to anyone who cared to pay for them (through his own bank) with a credit at the Bank of England, and, in fact, many more notes went into circulation than were needed to replace the gold coin, as the expansion of bank credit caused a demand for more hand-to-hand currency. Thus the total circulation of notes and coin is estimated for the end of 1918 at three times what it was in the first half of 1914.[3]

The question how far the increased issue of currency

[1] Feavearyear, p. 303. [2] Withers, *op. cit.*, preface, pp. viii–ix.
[3] Feavearyear, pp. 304, 334.

notes was responsible for the war-time inflation and rise of prices has been long debated. It was, no doubt, a necessary condition for the expansion of credit, since it removed what would otherwise have been a limiting factor. But it was not the direct cause of inflation, since the notes were not forced on the public: they were drawn into circulation as a rule only so far as the public and the banks wished to convert their bank deposits into cash.[1] The growth of bank deposits resting on the increased credit created by the Bank of England and expended by the Government was therefore the more important factor. The commercial banks restrained the process somewhat by increasing their reserve percentage.

As the banks drew out currency notes, corresponding amounts of their balances at the Bank of England were transferred to the Currency Notes Redemption Account. From this the Government borrowed against securities, and expended the proceeds, so that they came back to the bankers' balances. The net effect upon the bankers' balances at the Bank of England would be some small reduction, so far as a reserve was kept against the currency notes. But in the notes issued the banks gained fresh cash resources, which, whether they were paid out to the public or held as reserves by the banks, would certainly facilitate expansion of credit by them. The two processes of creation of more credit and issue of more currency were complementary, and went on all the time side by side. It is not possible to disentangle the influence of each separately, especially in view of the deficiencies in the statistical information about these matters for the War period.

The beginning of the process of war-time expansion of credit at the Bank of England was in its large advances to the market up to August 1st. After that the moratorium affected all bills, and it was impossible for the acceptance and discount markets to function normally. The result

[1] Feavearyear (p. 310) expresses the view that the Government "at times did force the note-issue indirectly by borrowing from the Bank and taking a part of the loan in its own notes."

was a breakdown in the exchanges and in foreign trade. It was estimated that bills outstanding amounted to £350 millions, and the Bank found this too huge a problem to tackle without a Government guarantee. After careful consultation between the Treasury and the Bank, it was notified on August 13th that the Bank would discount approved bills accepted before August 4th at Bank-rate without recourse to the holder. The Government guaranteed the Bank against loss. Moreover, acceptors were allowed to postpone payment at maturity by paying interest at two per cent. above Bank-rate, of which two and a half per cent. was to go to the Government. On September 5th, the further announcement was made that the Bank would advance funds to the acceptors to pay off these bills and not claim repayment till a year after the end of the War.[1]

Bills to the amount of some £120 millions were rediscounted under this scheme, and about £60 millions was advanced to acceptors towards paying them off. Of course, the full £120 millions was never outstanding at the same time. These discounts and advances were included under " Other Securities " in the Bank's statement, though they were liabilities of the Government. O.S. (" Other Securities ") increased by £80 millions between July 22nd and September 16th, whilst P.S. (" Public Securities ") increased by under £20 millions. In 1915 the Government paid £28 millions to the Bank and took over the advances to acceptors which were still outstanding. £20 millions was still due to the Government in 1919.[2] The bulk of this was repaid within the next few years. In the long run, the Government's receipts from the charge for its guarantee probably exceeded the losses.

The nature and extent of the advances by the Bank to the Government during and just after the War make up a very obscure problem. Such temporary advances are known as Ways and Means Advances, because they are

[1] Withers, *op. cit.*, pp. 65, 69, 149–52.
[2] S. E. Harris, " Monetary Problems of the British Empire," pp. 15–19.

made in anticipation of "Ways and Means," *i.e.* funds voted by the House of Commons.[1] It is generally assumed that borrowing by the Government on Ways and Means Advances provided the basis at the Bank of England for the general expansion of credit. But such advances seem to have been quite moderate, at any rate up to 1917. Just as in 1914 the important factors in the inflation of Bank of England credit were the rediscounting of pre-moratorium bills and the advances to acceptors under Government guarantee, so in 1915–16, according to Dr. Harris, large advances by the Bank to the Dominions and Allies were of prime importance. He states that these also appeared under O.S., though they were in effect Ways and Means Advances to the British Government, which repaid them in due course.[2] It seems probable that he has exaggerated the importance of this factor.

The Treasury figures for the floating debt during most of the War period only distinguish between (1) Advances on Treasury bills and (2) Other Advances. The latter include (1) ordinary Ways and Means Advances from the Bank of England, (2) Departmental Ways and Means Advances, and (3) Ways and Means Advances from the Bank of England against Special Deposits. The Departmental Ways and Means Advances represent funds in the hands of some Government Department not required for immediate disbursement by it. They are therefore borrowed by the Treasury for the purpose of general expenditure. Such Advances became very large from 1916, and it is believed that they represent largely the borrowing of the Bank of England balances owned by the Currency Notes Redemption Account. How far such borrowing was on the security of Treasury

[1] Before the War there were also "Deficiency Advances" made under a standing authority when the funds in hand at the end of a quarter were insufficient to pay the debt charges. These "Deficiency Advances" and "Ways and Means Advances" had, in the course of the nineteenth century, replaced the old form of temporary borrowing on Exchequer bills. See O. Hulftegger, "Die Bank von England," pp. 83–4.

[2] Harris, pp. 40, 98–9, 135–43.

bills and how far on Departmental Ways and Means Advances is not clear. Dr. Harris maintains that these Departmental Ways and Means Advances were deflationary in effect, as they represented funds that were kept off the market until the Government disbursed them.[1] Perhaps it would be truer to say, especially in regard to the balances in the Currency Notes Account, that there was a temporary postponement of inflation until the funds were spent and returned to the bankers' balances. Holding idle balances delayed inflation, but this effect ceased when they were borrowed and spent.

The Special Deposits are described by Dr. Harris as "a mechanism by which the Government and the Bank of England, by absorbing surplus cash, controlled the money market." It was considered desirable to keep up the market rate of interest, in order to retain foreign balances, and also to prevent the use of bank credit for non-essential purposes. From 1915, therefore, the Bank began to offer to pay interest on deposits by foreign institutions, and in 1916 the scheme was extended to British banks. When the foreign exchanges were causing anxiety, a higher rate was paid for deposits of foreign institutions than for those of British banks. These deposits were used in making Ways and Means Advances to the Government at a slightly higher rate of interest to repay the Bank for its trouble. It is claimed that these Special Deposits had a temporary deflationary effect until the proceeds were spent by the Government.[2] This effect would be limited in extent, because Special Deposits were practically cash reserves for the commercial banks and in some cases were actually included in their statements as cash.[3] However, it can safely be said that Ways and Means Advances against Special Deposits were not quite so directly inflationary as those of the ordinary type. The net effect of the ordinary Ways and Means Advance, after it was expended by the Government, was a plain increase in the commercial banks' cash balances. The net effect of the Special Deposit, after

[1] Harris, p. 62. [2] *Ibid.*, pp. 46–59, 149–50. [3] *Ibid.*, pp. 52–3.

it was expended, was that the commercial banks' ordinary balances at the Bank were restored to their former size, but they now had an additional asset in the form of a Special Deposit which would be either treated as cash or included in "money at call and short notice." Thus the ordinary Ways and Means Advance increased bankers' cash reserves, whilst the Special Deposit increased either their cash reserves or their "secondary" reserves.

The Special Deposits were kept in a separate account at the Bank, and not shown in the weekly returns, which therefore remained surprisingly stable. The amount can only be estimated very roughly. Dr. Harris regards them as a "happy contrivance."[1] Essentially they were equivalent to purchases of Treasury bills by the depositors. Mr. Hawtrey says that the system of Special Deposits was "intimately connected with the Government's practice of keeping Treasury bills on offer in unlimited quantities at a fixed rate of discount."[2] It would have been advantageous if all the surplus funds of the commercial banks could have been absorbed into Treasury bills, but evidently the banks were not willing to take so many. The Bank of England, therefore, borrowed their surplus balances, and advanced them to the Government.

The purchase of Treasury bills or any other Government securities by the Bank of England, beyond what was required to replace maturities, was as directly inflationary as its ordinary Ways and Means Advances. Similar purchases by the commercial banks were inflationary only in a lower degree, and so far as they involved a net increase in bank assets and deposits instead of replacing other assets. The effect of the Special Deposits was intermediate between these other two cases. Dr. Harris regards the repayment of Special Deposits in 1919 as inflationary. That seems to be a mistake, as he admits that the funds used for repayment must previously have been taken from the market. But such repayments were not necessarily deflationary, like those of ordinary

[1] Harris, p. 128. [2] Hawtrey, "Art of Central Banking," p. 152.

Ways and Means Advances.[1] There would be deflation so far as amounts repaid to the banks were not invested in other similar assets. This might be called secondary deflation of total bank deposits, as against primary deflation of bankers' cash.

The Bank of England stated officially shortly before the War that "the Government has no voice in the management of the bank."[2] In theory the position was the same throughout the War, but in practice the Government had almost full control, as in all departments of the national life. The Bank-rate, which had been five per cent. from August 8th, 1914, was put up to six per cent. on July 13th, 1916, and the Government had to accept some responsibility for it. In practice the Bank-rate was unimportant, and "of significance only because it reflected the Treasury rate on bills and on Special Deposits." Dr. Harris points out that

> "the Treasury controlled both the maximum and minimum rates on the market through its sales of Treasury bills at a fixed rate, its acceptance of Special Deposits, and its preparedness to borrow directly from the Bank of England when adequate supplies of cash were not forthcoming at the rates set on bills or on deposits."

The Government also exercised some direct control over the use of bank credit by the commercial banks, and the rate of interest paid to their depositors.[3]

Mr. Hawtrey has rightly emphasised the fact that "in face of the exigencies of war, no reliance can be placed on an independent central bank to resist demands from the Government." But he seems to go too far in saying that "in themselves protests are useless, nor in practice do central banks make them."[4] There are published letters from the Bank of England to the Treasury protesting against inflationary finance in July 1917 and March and September 1919. The protest in Sep-

[1] Harris, pp. 58, 154–5.

[2] National Monetary Commission: Interviews (61st Congress, 2nd Session, Senate Document 405), p. 8.

[3] Harris, pp. 124, 126.

[4] Hawtrey, *op. cit.*, p. 268.

tember 1919 was particularly strong. It is worth noting that as the Ways and Means Advances to which the Bank took objection at this time were very largely made out of Special Deposits,[1] the Bank evidently regarded these as inflationary. Since the Special Deposits were all paid off by the end of the year, it would appear that the Bank's protest was remarkably effective. This, of course, was after the War. How far the Bank's protests were effective in restraining inflation during the War is doubtful. In November 1914 the Bank pointed out that the inflation of credits was affecting the foreign exchanges adversely, and this seems to have induced the Treasury to cut down its demands for Advances from the Bank.[2] The Bank's advice was no doubt always treated with respect and given such weight as was deemed possible, though in the stress of the emergency it seemed essential to take action which was laying up much trouble for the future.

A striking illustration of the way in which the Government took over the responsibilities of the Bank during the War is the arrangement for "pegging" the exchanges. There was no prohibition of gold exports till 1919, but in practice exports did not take place during the War except on Government account. Private shipments could be prevented by refusing to insure them or charging a prohibitive rate under the War Risk Insurance scheme, and later, when the Government took control of all shipping, by refusing cargo space. Since the gold standard mechanism was not allowed to function, Government action had to take its place as far as possible. Shipments of gold, borrowing in America, and the requisitioning and sale abroad of American securities held in Great Britain were among the various devices used to obtain dollars and peg the pound at $4.76. At

[1] According to the estimates of Dr. Harris, *op. cit.*, p. 57, out of Bank of England Advances totalling £203 millions, Special Deposits accounted for £201 millions on September 20th, 1919.

[2] Parliamentary Papers, 1914–16, Vol. XXXVIII (103, 123), pp. 109, 115; 1917–18, Vol. XIX (176), p. 95; 1920, Vol. XXVII (20), p. 99.

the same time non-essential imports were severely restricted.[1]

During the first half of the War the Treasury kept very large balances at the Bank, which might seem to have unnecessarily increased the floating debt. This was partly due to the difficulty of keeping down balances when carrying on such large transactions, and partly to a deliberate policy of keeping cash off the market so as to counteract inflation to some extent. In 1917 and 1918 the Government kept its balances down to a minimum. They averaged about £30 millions, which, in view of the rise in prices, is only the equivalent of the average of £15 millions for a few years before the War.[2]

It was inevitable that under the conditions that prevailed during the War the Bank should make abnormal profits, just as it did a hundred years before in the Restriction period. But these profits were not used, as at that previous time, to make extra payments to the shareholders, and this is, no doubt, significant of the change in the general position and attitude of the Bank. Public opinion would certainly have been very hostile to payment of higher dividends by the Bank, especially as some of its business was done with the benefit of a Government guarantee. Presumably the Bank was not subject to the excess profits tax because its payments to the Government were regulated by special Acts of Parliament. However, at the end of the War the whole amount of its excess profits was handed over to the Government as "an absolutely voluntary act on the part of the Bank."[3]

The Government remained in full control of the situation after the War until 1921, when the system of selling Treasury bills by tender was restored, and Bank-rate resumed its old significance. On the policy of

[1] Harris, pp. 251–3. [2] *Ibid.*, pp. 98, 102–3.

[3] Evidence of Sir Ernest Harvey before the Macmillan Committee, Qns. 264–6. The Finance Accounts, 1918–19, p. 30, and 1919–20, p. 31, show that the Bank paid £2,579,620 to the Government as contributions towards the cost of the war.

deflation from 1919 the Government and the Bank were in general agreement. As Professor Clay puts it:

"The monetary policy of the country has been determined by them in co-operation, and it is impossible for any layman to discover the degree of responsibility that they must respectively bear." [1]

The Cunliffe Committee of 1918, presided over by Lord Cunliffe, who was Governor of the Bank of England from April 1913 to April 1918, recommended a policy of deflation by paying off a good deal of the floating debt (*i.e.* Ways and Means Advances and Treasury bills), and not allowing the fiduciary issue of currency notes in any year to exceed the maximum issued in the previous year. At that time it was generally agreed that deflation was essential, and that the objective of monetary policy should be a gradual return to the old parity with gold. Nevertheless, the Government hesitated about the Cunliffe Committee's recommendations until the winter of 1919–20. They then took vigorous action to stop further inflation and the unhealthy post-war boom that was developing. The rate on Treasury bills was raised in October and November, and the Cunliffe Committee's recommendation for the maximum fiduciary issue of currency notes was adopted in December. Direct pressure was put on the banks to restrict advances for speculative purposes, and Bank-rate was put up to six per cent. in November 1919 and seven per cent. in April 1920. On the whole the Government deserves considerable credit for preventing inflation from going further.

"It is indeed unfortunate (says Dr. Harris) that instead of proclaiming their contribution and receiving the plaudits of the country, the Government found it necessary to belittle them [*sic*], and to place full responsibility on the banks." [2]

The depression that existed from 1921 made an increasing breach in the unanimity regarding deflation; though it was still widely regarded as the best policy,

[1] H. Clay, "The Post-War Unemployment Problem," p. 59.
[2] Harris, p. 185.

much stress was laid on making it as gradual as possible. The Government was inclined to emphasise the discretion of the Bank, hoping to avoid some of the unpopularity that comes with hard times.[1]

Though the years 1922–4 were a time of relatively cheap money, there was constant stringency in the money market, which was to some extent due to Government action. The limitation on currency notes was of some importance. Between 1921 and 1925 the Government effected a net reduction of £50 millions in Ways and Means Advances from the Bank, which meant a serious loss of cash reserves for the market. The rest of the floating debt was also greatly reduced; this was not necessarily deflationary, but was so in practice, inasmuch as the banks were not able to replace Treasury bills by other suitable assets on account of the depression.[2]

Both the Government and the Bank were naturally eager to return to the pre-war working of the credit and currency system if possible, with the idea that that would be a long step towards the restoration of more satisfactory conditions of production and trade. It is only with wisdom after the event that everyone can now see that whilst it was right to check the boom in 1920, it was a mistake to continue deflation after the boom had been brought to an end. Similarly, in regard to the return to

[1] Harris, p. 182.

[2] *Ibid.*, pp. 210–13. The reduction in Ways and Means Advances was perhaps partly due to pressure from the Bank. Cf. Greengrass, "The Discount Market in London," pp. 92–3. He states that when discount rates were high after the War, the Treasury tried to economise by taking more Ways and Means Advances from the Bank instead of selling Treasury bills, and says: "Representations were made to the Treasury by the Bank of England, and the strength of the Bank was proved by . . . an agreement whereby Ways and Means Advances should be strictly limited to the occasions on which they were sought in pre-war days, viz. to tide the Treasury over a few days when expenditure temporarily anticipated revenue." It seems unlikely that the Treasury tried to economise in this way, or that the Bank extorted a definite agreement. The Cunliffe Committee protested strongly in August 1918 against the extent of Ways and Means Advances, and urged a return to the pre-war practice.

the gold standard in 1925, the reasons for this step seemed at the time overwhelmingly strong.[1] Mr. Keynes was almost alone in very strongly opposing it.[2] It is obvious now that the task undertaken was too difficult, and that action should have been delayed or the return should have been at a lower par.

Mr. Hawtrey contends, very plausibly, that the great mistake was the dear-money policy and restriction of credit from 1924. He thinks that, if cheap money had been maintained, the parity with gold would probably have been attained naturally in a short time without any strain. He also argues that the dear-money policy followed by the Bank continuously up to 1929 might often have been relaxed, and that it would have been better to let a good deal of gold go, in the hope of inducing a general credit expansion and improvement in world trade.[3]

The Gold Standard Act of 1925 established the gold bullion standard in the United Kingdom, on lines recommended by Ricardo a hundred years before, with a view to economising gold by not using it for internal circulation. The Government also accepted the recommendation of a Treasury Committee of 1924 that the note-issues should be amalgamated, as already proposed by the Cunliffe Committee. The old principle of a fixed fiduciary issue with all further notes covered by a hundred per cent. gold was to be applied, when experience had shown what would be a suitable total for the combined fiduciary issue such that the gold reserve could normally be kept at about £150 millions. By the Currency and Bank Notes Act of 1928 provision was made for replacing the currency notes by Bank of England notes. The maximum fiduciary issue of Bank-notes was fixed at £260 millions.

1 Sir Otto Niemeyer stated the reasons very clearly before the Macmillan Committee in defending the action taken in 1925, Qns. 6676–709.

2 J. M. Keynes, "Tract on Monetary Reform," 1924, pp. 177–91.

3 Evidence before the Macmillan Committee, Qns. 4153–203. Cf. "The Art of Central Banking," pp. 232–3.

Thus the note-issue system first set up by the Bank Charter Act of 1844 was restored in principle, with a much higher fiduciary limit and no provision for conversion into gold coin. An important provision, however, gave the Treasury special powers, on the lines first introduced in the Act of 1914, intended to avoid any necessity for a "crisis letter" in future and to give a reasonable degree of elasticity to the note-issue. At the request of the Bank, the Treasury could reduce the fiduciary limit for any stated period, or increase it for not more than six months at a time, but an increase was not to be effective beyond two years unless sanctioned by Parliament. A statement made by a Minister in Parliament, by agreement with the Bank, during the debate on the 1928 Act, indicated that the provision for an increase would be used if necessary (1) in a panic such as happened in 1847, etc., (2) to allow for large withdrawals of foreign balances in gold, (3) to mitigate a scramble for gold by Central Banks, or (4) to provide for normal growth of population and business.[1] It was also provided that the net profit made by the Bank from the assets set aside in the Issue Department to cover the fiduciary notes should be paid over to the Government. In the financial year 1929–30 the Bank of England paid £2,420,000 to the Government as the net profit on the fiduciary note issue, and in 1932–33 it paid £11,423,421 13*s*. 11*d*.[2] The interest on the securities less expenses is probably about £6 millions, but in calculating the profit allowance is made for changes in the market value of the securities.

The restoration of the pre-war arrangements, thus formally completed in 1928, was unfortunately not accompanied by any progress towards better times in the United Kingdom. In fact, there was rapid deterioration; blow followed blow in a terrible succession. The

[1] Hansard, May 14th, 1928, Cols. 744–6, quoted in the Macmillan Committee's Report, pp. 139–40. The Treasury permitted an increase of the fiduciary issue to £275 millions from August 1st, 1931, to March 31st, 1933. See the *Economist*, April 8th, 1933, p. 744.

[2] Finance Accounts of the U.K., 1929–30, p. 26; 1932–33, p. 24.

collapse of the American boom in 1929 was followed by world depression and a rapid fall of prices. This resulted in the world financial crisis of 1931, and the suspension of the gold standard in the United Kingdom and various other countries in September, as a result of an international "run" to withdraw funds from London. As Mr. R. McKenna put it:

> "For upwards of six years our monetary authorities fought a losing battle on ill-chosen ground. Looking back upon the long-drawn struggle we read a story of great and increasing sacrifice for a mistaken ideal." [1]

The Labour Government in November 1929 appointed a strong Treasury Departmental Committee (the Committee on Finance and Industry, usually known as the Macmillan Committee after its Chairman) to inquire into banking, finance and credit and suggest how these agencies could best promote trade and employment. Such eminent authorities as Mr. J. M. Keynes, Mr. R. McKenna and Professor Gregory were included. The Committee was taking evidence as the world crisis developed, and submitted its Report in June 1931, just as Europe was reaching the stage of financial panic. The evidence taken by the Committee is exceedingly informative and the Report a very valuable document. Unfortunately, it came too late to have much influence on the course of the crisis. Its strongest recommendation was for international action to raise gold prices and improve the working of the gold standard. But already the nations were being driven to drastic separate action, and it was becoming a case of "each for himself." It was soon clear that effective international action could not be expected in the midst of the chaos.

If such a Committee had been appointed a few years earlier, its work might have been much more productive of results. It seems a pity that a wide and authoritative investigation of this kind was not undertaken at least

[1] Speech of January 29th, 1932, in *Midland Bank Monthly Review*, January–February, 1932, p. 1.

before the amalgamation of the note issues in 1928.[1] As things turned out, its recommendations for international action were bound to be fruitless for the time being. The very sound suggestions for the better working of the internal credit system, and the publication of more useful statistical information, were also unduly neglected on account of the national emergency. It is alleged that "the Macmillan Report itself helped to expose the difficulties of the international financial position of London," and so to cause the international distrust which drove Britain off the gold standard.[2]

Since September 1931 sterling has been a "managed standard," with the Government in more or less direct control, as during the War. The monetary policy of the Government after a few months of hesitation definitely turned to cheap and plentiful credit, with a view to keeping up prices and helping trade and industry, as well as facilitating conversion of a great part of the War Debt to a lower rate of interest. Bank-rate fell from six per cent. in February to two per cent. in June 1932, and other Central Banks followed suit.[3] There was no aggressive movement by the British Government to raise prices, but at any rate sterling was prevented from following the further appreciation of gold and prices were kept fairly stable.

The declarations of the Governments of the Empire at the Ottawa Conference of 1932, and more particularly at the end of July 1933 after the World Economic Conference, reflected a growing desire for a rise in sterling prices, with the realisation that there was no serious danger of an inflationary movement that might get out of control. The policy is now clearly defined in theory. It is to raise sterling prices to a level "which

[1] There was some pressure for a public inquiry at that time in regard to the note issues, *e.g.* by Mr. R. McKenna and by the Liberal Party's Industrial Inquiry. See "Britain's Industrial Future," London, 1928, p. 416.

[2] *The Economist*, London, July 23rd, 1932.

[3] "World Economic Survey, 1932–33," League of Nations, 1933, p. 246.

restores the normal activity of industry and employment," and then to join in re-establishing the international gold standard, provided general co-operation can be relied on to prevent "undue fluctuations in the purchasing power of gold."[1] In practice little has been done to raise prices. The various indices of wholesale prices are now (summer 1934) between four and nine per cent. above what they were in September 1931.

As regards the exchanges, the policy has been to maintain stable rates within the Empire and with other countries choosing to adhere to what is sometimes called "Sterlingarea." With a view to maintaining reasonable stability of exchange rates with gold currencies, the Government established the Exchange Equalisation Fund in July 1932. The object was not to stabilise at any given rate, but to minimise fluctuations caused by "sudden movements of capital, psychological hopes and fears, and speculative operations."[2]

It seems to have been first intended that the Bank should operate the Exchange Fund directly and at its own discretion. The final arrangement was a separate Treasury organisation using the Bank as its banker and acting in close consultation with it.[3] Secrecy was considered essential in order to defeat the speculators. One unfortunate result has been that the power of the Fund has been greatly exaggerated abroad, and it is supposed to have artificially depreciated sterling. No doubt it would be possible for the Fund to establish an unnaturally low rate for sterling and in effect buy gold at a high price, as has been done with the dollar. But unless it had already been decided to devalue at least to this low rate, such a policy would mean acquiring gold at a price in sterling which might turn out to be higher than its final valuation, with a consequent indefinite risk of loss.

[1] *New York Times*, July 29th, 1933. Text of the declaration on monetary policy by the delegations of the British Commonwealth (except the Irish Free State) to the World Economic Conference.

[2] *The Economist*, London, May 13th, 1933.

[3] J. M. Kenworthy, "Our Daily Pay," p. 50.

The declared policy is to let the underlying market conditions fix the rate, and merely counteract undesirable short-term influences from speculation and capital movements. That this is also the practice seems reasonably certain. It would be a good thing if the accounts of the Fund's operations could be published periodically, after a sufficient interval to prevent any possible undesirable effect on current transactions.

Having thus brought down to the present time a brief account of developments affecting the joint concerns of the Government and the Bank, we shall now conclude this chapter with a sketch of their present relations and the proposals for change which are made in some quarters.

First, then, let us take Public Deposits. The Exchequer Account at the Bank represents the Consolidated Fund, through which as a general rule all public revenue passes on its way from those who receive it to those who pay it out. In addition, the Bank keeps separate accounts for certain Government Departments, including the great revenue Departments (the Board of Inland Revenue, the Board of Customs and Excise and the Post Office), and the Pay Office representing the spending Departments. Every such account of a Department or officer of the Home Government requires the sanction of the Treasury before it is opened, and the balance will be included in the total of Public Deposits shown in the Bank's weekly return.

In Scotland each of the six principal banks takes it in turn for a year at a time to conduct the Exchequer business as agent for the Bank of England.[1] In Northern Ireland the Belfast branch of the Bank of Ireland acts independently as banker to the Government of the United Kingdom, just as the Head Office in Dublin did in regard to the whole of Ireland before the Irish Free State came into existence. The Dublin and Belfast offices of the Bank of Ireland act separately in the management of the British National Debt for the relatively small amounts registered with them.

[1] H. E. Fisk, "English Public Finance," p. 159.

The officers of the Revenue Departments throughout the country have their own local banking accounts in such branches of the Joint Stock Banks as may be convenient. Into these the tax collections are paid, and each officer instructs his bank to remit the bulk of the balance daily, or at frequent intervals, to the Bank of England for credit to the account of his Department. From the Department's account at the Bank transfers are made, as a rule daily, to the Exchequer Account. The procedure is complicated by the fact that both local officers and the Head Offices keep sufficient balances in their bank accounts to pay departmental expenses. This is done for convenience and economy of balances. Later on, the Treasury makes an issue from the Consolidated Fund for the expenses, and the same amount is repaid to the Consolidated Fund, a double transfer which cancels out, but satisfies the rule that all revenue ought to be paid into the Consolidated Fund.[1]

The Exchequer Account is in the charge of the Comptroller and Auditor-General, who from time to time grants credits on it to the Treasury on its application and within the limits of the funds granted by Parliament. The Treasury then makes transfers as needed to the Paymaster-General's (*i.e.* Pay Office's) Supply Account. This is also called his Exchequer Credit Account, to distinguish it from his Cash Account at the Bank, into which various Departments pay cash receipts which they are authorised to use as "Appropriations in Aid" towards their expenses without passing them through the Consolidated Fund. The Paymaster-General has two other accounts from which the actual disbursements are made.

[1] Hills and Fellowes, "The Finance of Government," pp. 67–73. In 1848 the House of Commons resolved "that this House cannot be the effectual guardian of the Revenues of the State unless the whole amount of the taxes and the various other sources of income received for the Public Account be either paid in or accounted for to the Exchequer." See E. Hilton Young, "The System of National Finance," 1924 edition, pp. 7–8. For the special arrangements in regard to expenditure of Revenue Departments, cf. Willoughby, Willoughby and Lindsay, "The System of Financial Administration of Great Britain," p. 153.

The Drawing Account is for home payments, and the Bills Account is for payment of the bills drawn and sold abroad by Treasury Chest Officers to raise funds for disbursements outside the country. The spending Departments give drafts on the Pay Office to their home creditors, sending duplicates direct to the Pay Office as a check. A draft may be presented at the Pay Office for payment in cash, for which purpose a small cash balance is kept and replenished as may be necessary from the Drawing Account. But as a rule the drafts are paid in to customers' accounts in the commercial banks, which present them to the Pay Office. The Paymaster-General checks them and pays by "write-off," *i.e.* an order to the Bank of England to make a transfer from his Drawing Account to the account of a certain commercial bank. Thus drafts on the Pay Office are not paid in cash at the Bank, which therefore bears no responsibility for identifying claimants or risk of loss through wrong payments. The big spending Departments, chiefly the Army and Navy, have a number of local paymasters in places where they need to make large cash disbursements. These paymasters obtain funds by drafts on the Pay Office and have their own local banking arrangements just like the revenue officers.[1]

In the Paymaster-General's Cash Account, besides the departmental receipts mentioned above, are held the balances of (1) the Treasury Chest Fund, a working fund for profit and loss on foreign exchange transactions with Treasury Chest Officers (from time to time this is adjusted to a fixed sum), (2) the Civil Contingencies Fund, from which the Treasury can sanction small advances for unforeseen expenditure which it will ask Parliament to vote later, and (3) various Deposit Funds representing money (not revenue) that comes into the hands of Government Departments in the course of their business to be held for some special purpose. The Paymaster-General, of course, keeps detailed accounts under each "vote" passed by Parliament, to see that expenditure does not

[1] Hills and Fellowes, pp. 87–92.

exceed what is granted under that head. But the whole of his balances are treated as a single fund to be drawn on for all lawful payments. Thus he will use up the whole balance in his Cash Account before drawing on his Supply Account, and only when the Supply Account is drawn down to a minimum will he ask the Treasury for further transfers from the Exchequer Account. Only roughly at the end of each month and accurately at the end of the financial year are adjustments made, so that the amounts issued to and paid out by the Pay Office under each separate vote will balance. Thus the utmost possible economy of balances is achieved.[1]

The Bank continues to act, as it has done for so long, as the Government's agent for the management of the National Debt. It advises the Treasury as to the terms for new or conversion issues, makes all the arrangements, keeps the registers and carries out transfers, and pays the interest and repayments of principal. Naturally the work expanded to several times its previous size during the War, and has remained at a high level. This is the chief reason for an expansion in the Bank's staff from about 1,000 before the War to nearly 4,000 in recent years.[2] For the purpose of interest payments, the Treasury issues money from the Exchequer Account direct to the Chief Cashier of the Bank, who holds it in a Dividend Account, the balance in which is included in Public Deposits. Formerly the whole amount falling due on any day was transferred at once to the Bank, but now only such an amount is transferred daily as the Bank estimates from previous experience will be enough to meet claims that will actually be made that day.[3] This was one of Gladstone's financial reforms, and was stoutly resisted by the Bank when first proposed. It is interesting to note that the dividend payments by the Bank are not audited by any Government officer; they were formerly audited by

[1] Hills and Fellowes, pp. 92–7.

[2] Sir Ernest Harvey's evidence before the Macmillan Committee, Qn. 95.

[3] *Ibid.*, Qns. 203–6.

the Comptroller and Auditor-General, but the practice ceased in 1870.[1]

The payments to the Bank for managing the National Debt were fixed by the Bank Act of 1892, and they were made liable to revision from 1912. Under that Act the payment for managing the long-term debt was £325 a year on every million pounds up to £500 millions and £100 a year for every further million pounds. For this calculation annuities are capitalised at fixed rates. The remuneration for managing Treasury bills was fixed in 1892 at £200 on every million pounds outstanding on December 1st in each year.[2] The payment for managing Exchequer bonds was £100 a year per million pounds from 1907. These terms were not changed in 1912, but were varied a great deal by Treasury agreements made under the War Loan Acts, 1914–19. From 1920 a fixed amount of £17,500 a year has been paid in respect of Treasury bills, and £150 and £100 a year per million pounds of Registered and Unregistered Bonds respectively. For the long-term debt (Registered Stocks) payment per million pounds of the excess over £500 millions was raised from £100 to £175 a year during the War, and reduced to £150 a year in 1920. From 1922–23 the higher rate of £325 a year per million pounds was paid on the first £1500 millions instead of £500 millions; this amount fell to £750 millions in 1927–28, and has not been changed since. In 1932–33 £865,338 was paid to the Bank for its management of the National Debt.[3]

The Government's floating debt consists of: (1) Ways and Means Advances from Public Departments, (2) Treasury bills, and (3) Ways and Means Advances from the Bank of England, stating them in the order in which they would normally be utilised. The Treasury, of course, will not borrow unless the balance in the Ex-

[1] Epitome of the Reports from the Committees of Public Accounts, 1857–1925 (Cd. 161 of 1927), p. 23.

[2] Andréadès, pp. 399–401. Cf. Acres, Vol. II, p. 547.

[3] Annual Finance Accounts of the United Kingdom.

chequer Account is likely otherwise to prove insufficient for the issues required. It is perhaps a pity that the Advances by Public Departments have to be included in the statement of the floating debt, as they do not represent borrowing from the public or the Bank, but only temporary borrowing for general purposes of money that is already held by the Government. These Advances are essentially similar to the amounts, already mentioned, held by the Paymaster-General in Deposit Funds in his Cash Account, and utilised by him for expenditure, except so far as the Treasury directs him to invest them. Such Deposits are not included in the floating debt. Perhaps some amounts have to be taken as Advances because there is a legal objection to placing them as Deposits with the Paymaster-General, or because interest ought to be paid on them. The interest on the Advances by Departments is limited by statute to five per cent., and in recent years has been much less; no doubt it varies roughly with the Bank-rate. The Departments making Advances include the National Debt Commissioners, who may advance Post Office Savings Bank money pending investment, and the Public Trustee. They have their own separate accounts at the Bank. Curiously enough, the Paymaster-General's balances are sometimes drawn on for an Advance (without interest) to the Exchequer Account! [1] This would presumably only happen when he had funds to spare from his Cash Account and money was needed for the Dividend Account. Everything possible is done to mobilise cash resources in the hands of the Government before borrowing elsewhere.

Treasury bills are the means by which the Government borrows at short term from the market, and by far the

[1] Hills and Fellowes, p. 184.

It is stated by Dr. C. Hérisson in "Le contrôle du credit à court terme par la Banque d'Angleterre," p. 364, that Advances are also made by the Revenue Departments. This seems to be a mistake. If they had any revenue balances, the Treasury could have them paid into the Exchequer Account at once. There is another mistake on p. 365, in the statement that the accounts of certain Departments, such as Customs and Excise, at the Bank "are included in the Exchequer Account."

most important part of the floating debt. They were first used in 1877 at Bagehot's suggestion.[1] Down to 1914 the amount outstanding did not exceed about £15 millions, but during the War it was vastly expanded, and has never been reduced much below £600 millions since the War. From 1932 the amount outstanding has increased again considerably on account of the bills sold to provide funds for the Exchange Equalisation Account. Evidently the bulk of this is really permanent debt, and the Treasury must have power to issue bills to replace maturities, so long as anything like this amount is kept out. So far as the bills are issued to meet a purely temporary excess of expenditure, the rule holds that they must be paid off within the financial year. Treasury bills may run for any period up to a year, but are normally three months' bills, and are of the same type as the bank bills and trade bills familiar to the discount market. Hence they find a ready market, as a rule. Banks and discount houses and other financial institutions have become accustomed to holding them and, as commercial bills have become less plentiful, any drastic reduction in the volume of Treasury bills would certainly cause difficulties. At the same time, the Bank and the Treasury feel that too large a volume of Treasury bills is dangerous, as there may be difficulty at times in getting an issue taken up at reasonable rates. The Bank itself holds Treasury bills, and is able to vary the size of its holding when it wishes to regulate the cash at the disposal of the market. The Treasury adjusts the relation of issues to maturities so as to avoid holding idle balances. Tenders are received by the Bank every Friday, and opened in the presence of a representative of the Treasury, who decides what amount shall be issued, and it is then allotted to the highest tenderers. Payment is accepted on any day in the following week to

[1] They must not, of course, be confused with the "Treasury bills" to which the Bank raised such strong objection at the end of the eighteenth century. Those were bills drawn to raise funds by officers abroad, just as the Treasury Chest Officers abroad now draw bills on the Paymaster-General and sell them for cash.

be specified in the application, and repayment takes place three months later.[1]

If the Treasury is not able to adjust its position so as to avoid over-drawing the Exchequer Account, then it will ask for permission to over-draw temporarily, *i.e.* it will take a Ways and Means Advance from the Bank, and repay it in the course of a few days as revenue comes in or more Treasury bills are issued. These Advances are usually very small, except for a few days when War Loan dividends are paid around June 1st and December 1st. Sir Ernest Harvey told the Macmillan Committee that normally such Advances would not be necessary in the first part of the year, but a special effort was being made to keep down Government balances, and not deprive trade and industry of credit. As a result, he found that in 1929 the Government had an Advance outstanding from the Bank on ninety-two out of 300 working days, and in 1930 up to July the same applied to over twenty-five per cent. of the working days (Qn. 8848). The Bank enters the Advance in its accounts under " Public Securities." These Advances are now used strictly to cover temporary deficiencies, as before the War, and must be repaid by the end of the quarter following that in which they are made. The rate of interest is limited by Statute to five per cent.[2] Sir Richard Hopkins told the Macmillan Committee (Qn. 5317) that not more than £5 millions would be needed, except for the dividend dates, and up to that amount the usual rate of interest was one per cent. On the next £5 millions the rate would be two and a half or three per cent., and for anything above £10 millions it would be a half or one per cent. below Bank-rate. The exact terms are agreed on by the Chancellor of the Exchequer and the Governor of the Bank, and the total interest payment in a year is very small. Unless the Bank simultaneously sells securities to offset

[1] Hills and Fellowes, pp. 185–9. Evidence of Sir Ernest Harvey (Qns. 454–61, 7596) and of Sir Richard Hopkins (Qns. 5429–60) before the Macmillan Committee.

[2] Hills and Fellowes, p. 185.

their effect, Ways and Means Advances temporarily increase bankers' cash. It was stated by Mr. McKenna (Macmillan Committee, Qns. 5364–6) that the Bank does not in practice sell securities for this purpose.

A very interesting and difficult problem in regard to Public Deposits and Treasury bills is that of the nature and extent of any abnormal influence that their fluctuations may exert on the money market in the months January to March. This is the last quarter of the financial year in the United Kingdom, and is marked by a very rapid influx of revenue and a temporary excess of revenue over expenditure. The indirect taxes produce a fairly steady monthly flow of revenue throughout the year, but payments for the income tax, and especially for the super-tax, are largely concentrated in this last quarter of the fiscal year. So far as it is deducted at the source on salaries, dividends, etc., the income tax tends to come in steadily throughout the year. For the super-tax, however, and for the ordinary income tax on some kinds of income, the assessments for the year are made in the course of the summer and autumn, and the tax becomes due and payable either in full on January 1st, or in two instalments on January 1st and July 1st.[1] The payment dates are not rigidly enforced, but there is considerable pressure to get in the amounts due on January 1st at least by the end of March, so as to include them in the revenue for the financial year. It would be a great improvement in some ways if the arrangements could be modified so that payments were made in four quarterly instalments, as in the United States.

It is usually stated that this influx of revenue produces a rise in Public Deposits at the Bank in the first quarter of the calendar year, and that there would be a consequent reduction in the Bankers' Deposits but for the action taken by the Bank of England to offset this by buying securities. No doubt this was the position formerly, but it is not so simple as that in recent years. A glance at

[1] M. B. Carroll, "Taxation of Business in Great Britain," Dept. of Commerce, Washington, 1928, p. 64.

the monthly averages of the Wednesday figures of the Bank of England given in the Macmillan Report (Appendix II) shows that Public Deposits are not now very appreciably larger than usual in the first quarter, and that they sometimes rise and sometimes fall over that period. Thus over the years 1925–30 the Public Deposits averaged £15·6 millions in the first quarter and £15 millions for the rest of the year. However, it appears that during the first quarter a disproportionately large part of the income tax payments reaches the Bank on Thursdays. The average excess of the Thursday payment over the average daily payment in the first quarter was estimated by a Treasury representative in 1930 at £3 millions. He stated that the excess was much smaller than formerly, and could be further modified if necessary.[1] So long as it exists, the market may clearly be deprived of cash by tax payments to an extent not indicated by the Bank returns. Mr. McKenna complained that there was always a lag of a few days each week between the payment of funds to the Government on Thursday and the return of these funds to the market (Macmillan Committee, Qns. 7594–5), though he recognised that efforts had been made to improve the position.

It is not possible to find out whether the bankers' cash reserves as a whole decline in the first quarter by looking only at their deposits with the Bank of England, which undoubtedly do fall as a rule. The holdings of notes and coin must be allowed for, and this is done in Table I on p. 95.

It should be noted that these figures did not become available till 1931, when the Clearing Banks' figures for coin and notes were published by the Macmillan Committee. Mr. Keynes suggested that " the alleged failure of the Bank of England to mitigate the severity of tax collection in the Spring " might be due largely to its

[1] Evidence of Sir Richard Hopkins before the Macmillan Committee (Qn. 5426). It should be noted that Sir Ernest Harvey furnished some figures which, he said, tended to show that Public Deposits were not higher as a rule on Thursday than on Wednesday (Qns. 801–9). These were not published, and it is not clear whether they really met the point.

TABLE I

CASH IN HAND AND BALANCE AT THE BANK OF ENGLAND OF THE TEN LONDON CLEARING BANKS.

(£ millions.)

(Based on Monthly Statements which are averages of figures for a particular day each week for each bank.)

Year.	Average (excluding June and December.[1]	January.	February.	March.	Average (first quarter).
1919	198	198	185	198	194
1920	180	202	180	166	183
1921	202	205	193	184	194
1922	197	205	190	205	200
1923	188	189	193	176	186
1924	187	188	194	181	188
1925	186	186	188	179	184
1926	184	181	187	182	183
1927	185	185	188	179	184
1928	183	185	176	176	179
1929	182	189	184	186	186
1930	182	182	176	170	176
1931	182	198	190	184	191
1932	184	180	173	174	176
1933	212	214	208	207	210
1934	—	223	209	219	—
Average 1919–33	195	192	187	183	188

[1] The figures for June and December are excluded from the annual averages to avoid the effect of half-yearly "window-dressing" operations, which was very considerable before 1933.

Compiled from Table I in Appendix I to the Report of the Macmillan Committee, and (from 1931) from the monthly Statistical Summary published by the Bank of England. The former excludes, and the latter includes, the figures for offices of the National Bank outside England.

not having this information (Macmillan Committee, Qn. 812), but the difficulty seems to be more fundamental.

From Table I it appears that almost every year (1929 and 1931 were exceptional years with special influences at work) shows a fall of bankers' cash either in February

or March or in both months below its normal level for the year to the extent of £5 millions to £10 millions. It seems safe to conclude that a certain withdrawal of cash from the market in the first quarter of the year does still take place, and is not offset by the Bank of England.

So far as the Treasury keeps down its balances in the first quarter, it is done mainly by reducing the volume of Treasury bills, letting new issues fall below maturities each week. This produces at the same time (1) low rates of interest in the discount market owing to competition for the smaller volume of bills, and (2) a tendency for the banks to restrict the volume of credit, because they cannot place their usual proportion of funds in liquid assets, including bills and money at call with bill-brokers. The first effect may involve danger of a fall in the foreign exchanges and an outflow of gold, and for this reason probably the Bank is not in a position to create additional credit in order to keep up the bankers' cash. It is more likely to have to restrict credit to protect the foreign exchange position.

The tendency of bank advances is clearly upward as a rule from January to March with a check to the rise or a slight fall in April.[1] It seems likely that this check in the spring is connected with the unfavourable effects on the banks' power to lend resulting from the influx of revenue in the first quarter. Under present arrangements, the Treasury and the Bank seem to be in the dilemma that they must either let Government balances pile up in the first quarter, or else reduce the volume of Treasury bills outstanding below normal, with equally bad effects. It is no wonder, as Mr. Keynes pointed out, that

> "it has been a matter for jocular remarks in the Press that the bankers in their speeches at the annual meetings, which take place early in the year, say how splendid trade is, and three months later there has always been a set-back." [2]

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[1] This appears from the monthly figures, 1925–31, for London Clearing Banks, in the Macmillan Report, App. I, Table I.

[2] Macmillan Committee, Qn. 7582.

The remedy suggested by Sir Ernest Harvey to the Macmillan Committee was that the banks should ignore a seasonal fall in their proportion of bills discounted. Mr. Keynes proposed that the Bank of England should also sell Treasury bills from its holdings in the Issue Department and replace them by securities of longer date. In this way it might attempt to reduce fluctuations in the supply of bills to the market and keep up discount rates so far as necessary, without reducing the total volume of credit. Sir Ernest Harvey pointed out that the credit created by buying the long-term securities might come back on to the short-term market, leaving the excess of funds seeking an outlet there as before.[1] It does not appear that the Bank of England has adopted Mr. Keynes' suggestion. Money market reports for February and March still almost invariably refer to the influx of revenue as causing a heavy seasonal reduction of Treasury bills, with consequent low discount rates, and at the same time a withdrawal of cash into Public Deposits and a certain shortage of funds in the market.[2] Perhaps a shortage of funds and a shortage of bills could be made to cancel out as far as the discount market is concerned. But the danger of a restriction on the banks' powers to lend at a time of the year when there should ordinarily be an increasing demand for advances would still remain, and seems to be important. The only certain remedy would be an arrangement for the collection of income tax in instalments spread evenly over the year.

We pass now to the general relations between the Government and the Bank. The Deputy Governor, Sir Ernest Harvey, told the Macmillan Committee (Qn. 454) that they are " completely close, completely cordial." The following is a part of his interesting description :

" The relations are fundamentally those of banker and client. The Bank . . . is in daily touch with the Treasury, sometimes

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[1] Macmillan Committee, Qns. 7582–95.

[2] See *Lloyds' Bank Monthly Review*, 1932, pp. 72, 115 ; 1933, pp. 62, 106 ; 1934, pp. 69, 115.

many times a day. Probably twice in the week—if circumstances require it may be oftener—the Governor himself will pay a visit to the Treasury, sometimes accompanied by myself. When he is away, I pay such visits in his place. We have no secrets from them, we keep them fully acquainted as to the general trend of affairs in the City and the outlook, as we see it. We, on our part, never venture to interfere on any . . . political question, unless we are asked to express an opinion as to what the financial effect of a certain political operation may be. If we are asked, we give our advice, but we never seek to interfere in politics. The Treasury, on the other hand, are good enough to reciprocate; that is to say, that, whilst we keep them fully informed as to the general trend of affairs in the City, as to any occurrences of importance affecting the position of finance and credit, they do not seek to dictate any alternative line of financial policy if we, in our judgment, consider a particular line of policy essential for the protection of the country's main reserves. As regards other Government Offices, we have no direct contact without the knowledge and approval of the Treasury. In fact, it is with few of them that we have direct contact at all. If other Government Offices desire the opinion of the Bank on any subject, as a rule they obtain it through the Treasury. Apart from these visits . . . it is the practice for the Governor to visit the Chancellor of the Exchequer at fairly frequent intervals, and to keep him also fully informed. . . . I need hardly say that the colour of the Government of the moment has absolutely no influence whatever on the nature of these relations."

The Committee of Treasury, an inner cabinet in the Court of Directors, seems to have been originally intended to "attend the Treasury" and conduct negotiations with the Government, but also acquired other "indefinite powers."[1] In Bagehot's day seniority was the sole qualification, as the Committee was made up of Directors who had "passed the chair," *i.e.* acted as Governor. Sir Ernest Harvey stated in 1929 that it is now a Committee of nine Directors, of whom only the Governor and Deputy Governor are ex-officio members, and the others are elected by a secret ballot of the whole Court in which any Director is eligible. A recommendation for a change in the Bank-rate would come from this Committee. It is

[1] Bagehot, "Lombard Street," 1919 edition, p. 201, and Richards, pp. 174, 176.

rare for more than one or two members of the merchant banking houses in the City to be elected to this Committee. In fact, Sir Ernest pointed out that the " historical tradition " of electing Directors from among the merchant bankers has not been followed quite so closely in recent years (Macmillan Committee, Qns. 95–112).[1] However, industrialists are still poorly represented, and the Court is often criticised as representing rather the financial and international interests of the City of London than the trade and industry of the country as a whole. Bagehot's criticism as to lack of continuity in the policy of the Bank on account of changes of the Governor and Deputy Governor every two years no longer applies. The present Governor, Mr. Montagu Norman, has been elected every year from 1920, and the Deputy Governor, Sir Ernest Harvey, from 1929. Both seem to have become more or less permanent, whereas Bagehot only wanted a permanent Deputy Governor.[2]

Before the Macmillan Committee, Sir Ernest Harvey stressed his reluctance " to see any step which in any way seemed to affect the fact that the Bank is a private Corporation " (Qn. 271). He was not in favour of changing the arrangement by which the net profits of the fiduciary note issue go to the Treasury. Under a different arrangement he thought it conceivable that an impecunious Chancellor of the Exchequer might press the Bank to earn more profits so as to increase the Govern-

[1] Since the War several Directors have been elected who represent new types of experience on the Court. Sir Basil Blackett and Sir Josiah Stamp are former civil servants in the Treasury and the Inland Revenue Department respectively, who have won great distinction both in economics and in practical affairs. Sir Ernest Harvey and Sir Gordon Nairne were permanent officers of the Bank, who had worked their way up through all grades of its staff. Sir Charles Addis was connected with the Hongkong and Shanghai Banking Corporation, one of the leading Exchange Banks of the British Empire.

[2] By a recent change in its by-laws the Bank has taken power to pay suitable remuneration to some of the Directors in order that they may give their full time to the administration of the Bank, as the Governor and Deputy Governor already do. *The Economist*, London, September 24th, 1932.

ment share, or might look to an alteration in the proportion going to Government as a resource in hard times. He pointed out that the increase in the nominal rate of dividend from ten to twelve per cent. since the War is not really an increase, since the ten per cent. was paid free of income tax and the twelve per cent. is subject to payment of income tax by the recipient. As long as the Bank showed no tendency to distribute unduly large amounts, he would not favour a stabilisation of dividends at the existing figure, as suggested by Mr. Keynes (Qns. 257–73). Evidently the Bank sets great store by its status as a private company, and the resulting formal independence of Government control.

The importance to the public of the independence of the Bank is often emphasised from various points of view. Thus in regard to the management of sterling, Mr. L. S. Amery thinks it very fortunate that "sterling . . . is managed not by a Government subject to ordinary party influences, but by a powerful independent corporation carrying on a great tradition and imbued with a high sense of national and international responsibility." [1] Mr. E. T. Powell thinks it fairly certain "that the Bank would not be the power that it is if fate had made it a purely Government institution." [2] From the constitutional view-point, Mr. Hawtrey states that "the independence of the Bank is as essential to the Exchequer system as the independence of the Comptroller of the Exchequer himself, and it is as unassailable." [3]

The verdict of an American writer, already quoted, as to the relations between the Bank of England and the Treasury, is interesting. "The governor and directors of the Bank of England," he says, "although chosen by private stockholders, actually work in closer harmony with government officials than do the officials of the

[1] L. S. Amery, "A Plan of Action," London, 1932, p. 270.

[2] E. T. Powell, "The Evolution of the Money Market," London, 1915, p. 217.

[3] R. G. Hawtrey, "The Exchequer and the Control of Expenditure," London, 1921, p. 18.

Reichsbank where the governorship must be approved by the state." He also states the undoubted fact that "with respect to a clear-cut sense of international responsibilities, the men of the Bank of England rank at the top of the list" of the central bankers of the world.[1]

For some time before the Labour Party came into power in 1929 its official programme contained a provision for the public ownership and control of the Bank of England, and a proposal to appoint representatives of the Treasury, the Board of Trade, Industry, Labour and the Co-operative Movement as Directors.[2] In 1926 Mr. Maxton, M.P. and other members of the Independent Labour Party introduced a Bill "for the national acquisition and control of the Bank of England" (Parliamentary Papers, 1926, Vol. I, Bill 18 at p. 89), but for a technical reason it did not get a second reading. The Liberal Party's Industrial Inquiry in 1928 regarded the Bank as an admirable example of a "semi-socialised" institution, but wished to clarify its position as a national institution not representing a narrow class or working in the interests of private shareholders. The following four reforms were proposed: (1) Fixed dividends; (2) Fewer Directors and a reconsideration of the method of appointment and qualifications of Directors; (3) Fixing the term of the Governor at five years, renewable for five years more; and (4) "The co-operation between the Treasury and the Bank of England, which has inevitably become much closer than it was in pre-war years, should be expressly provided for in the inner Management of the Bank."[3] This last point presumably contemplates the appointment of a Treasury representative as a Director.

The case for changing the constitution of the Bank perhaps gained some support on account of revelations made by Lord Beaverbrook in 1928 as to the war-time

[1] Lionel D. Edie, "The Personnel of Central Banks," in *American Bankers' Association Journal*, January 1930, pp. 77–81.

[2] R. Hopkins, "The Control and Reform of the Bank of England," p. 10. L. D. Edie, "The Banks and Prosperity," pp. 14–15.

[3] "Britain's Industrial Future," pp. 414–15.

relations between the Government and the Bank. He asserts that

"the late Lord Cunliffe, who presided over the Bank, had found its importance, and consequently his own, swollen out of all proportions by the advent of war conditions. He became practically a dictatorial authority. In Lloyd George's time at the Treasury, the Chancellor and the Governor had worked amicably enough together . . . probably in virtue of the Governor having his own way entirely . . . but Cunliffe soon became a thorn in McKenna's side. . . . Eventually McKenna asserted the claims of the Treasury, though it was not until Bonar Law's Chancellorship that a final pitched battle took place, which resulted in Lord Cunliffe's ultimate retirement."

Lord Beaverbrook says that on one occasion Lord Cunliffe failed to provide for funds urgently needed for payments in New York, though he always asked for such matters to be left to him, and that but for drastic action taken by Mr. McKenna there would have been irretrievable damage to British credit.[1] Of course it may be claimed with much justice that even if the best man for the post was not Governor of the Bank during the War, it does not necessarily follow that any change should now be made in the system. It is generally agreed that the Bank has improved its practice greatly by re-electing the present Governor every year since 1920. Opinions differ widely as to the real merits of Mr. Montagu Norman's leadership. But clearly the Bank now tries to elect the best man available and keep him in charge for a reasonably long period. Lord Cunliffe became Governor in 1913 under the old system, which gave each Director two years as Governor in the order of seniority.

It was generally assumed that one purpose of the appointment of the Macmillan Committee was a thorough investigation of the working of the Bank of England to enable the Labour Government to decide whether it would propose any changes. But there was surprisingly little general criticism of the Bank, or suggestion that any drastic change was required. Some witnesses,

[1] Lord Beaverbrook, "Politicians and the War, 1914–1916," pp. 161–5.

especially Mr. Hawtrey, thought its policy had been unduly restrictive. Industrialists on the whole regarded "the Bank of England as having put up a very fine fight against impossible circumstances" since the return to the Gold Standard (Qn. 3242). The only witnesses who seem to have expressed in a very mild way the orthodox Labour Party view are those who appeared for the Co-operative movement. They said they would like to see more Directors connected with trade and industry. They did not wish to criticise the membership of the Court or suggest that the Bank had acted unwisely in any way. But they reported a general feeling among the working classes that the Bank had great power over the economic condition of the nation, and that its Directors should therefore be appointed by and responsible to some public authority instead of private shareholders. They admitted the difficulty of keeping the Bank free from politics if the Directors were to be appointed by Parliament or the Government (Qns. 6308–31).

The one witness who expressed strong dissatisfaction with the Bank and made definite proposals for a different system was Mr. E. F. Wise, M.P., representing the Independent Labour Party. He advocated nationalisation not only of the Bank of England, but also of the Joint Stock Banks. In his view the Bank had "definitely put the prestige of the City in international finance before the needs of industry and of employment." He would be prepared to devalue sterling if necessary in order to provide adequate credit at home, but thought it should be possible to avoid that. The constitution he recommended included an Executive Board of men with high technical qualifications, and a Banking Council representing "financial, banking, industrial, labour and consumers' interests." Apparently this Council would meet to give binding advice on changes in the Bank-rate, and so in effect decide the Bank-rate itself. The members of the Executive Board and the Banking Council would be appointed by the Government, and could be dismissed in the last resort. But the witness contemplated that

considerable freedom would be given to them in practice. He quoted details as to existing semi-independent Boards and Commissions, which, though appointed by and responsible to the Government, work satisfactorily. Disagreeing with Mr. Keynes as to the merits of the existing method of electing Directors, which practically amounts to co-option similar to that practised by the Fellows of a College, he insisted that the Government could be trusted to take proper advice and make good appointments. He was particularly opposed to "Treasury control of the Bank of England," on the ground that the Treasury is apt to be too particularly concerned with the Budget and the financial aspect of affairs, and he would like other public Departments connected with industry also to have close relations with the Bank. Special stress was laid on the difficulty of allotting responsibility as between the Government and the Bank at present. Mr. Wise thought the position must be unsatisfactory to the Bank, since the Chancellor of the Exchequer could exercise considerable influence on its decisions, and yet throw all the blame on the Bank if anything went wrong. As a Member of Parliament, Mr. Wise stated that he had found it impossible to get information about the relations and communications between the Treasury and the Bank, as questions were always ruled out of order.[1]

The main Report of the Macmillan Committee did not even refer to any proposals for changing the constitution of the Bank. They regarded the Bank as "an excellent instrument" for control of the monetary system,

> "independent of political influences, yet functioning solely in the public interest; with long traditions and experience and clothed with vast prestige, yet not distrustful . . . of evolutionary change or hesitant of new responsibilities; entrenched in the centre of the struggle for profit and with access to the arcana of the market, yet itself aloof and untinged by the motives of private gain."

Again the Committee say:

[1] Macmillan Committee, Minutes of Evidence, Vol. II, pp. 134–46.

"We have received evidence of the Bank's willingness to adapt itself to the new conditions and problems with which it has found itself presented. It would not be a true picture to portray new and lively elements of contemporary thought and enterprise springing up elsewhere in the City but held down by the weight of the conservatism of the Bank of England." [1]

The Committee did, however, recommend new arrangements for the note issue, holding that the fixed fiduciary system is out of date, and also a new arrangement by which the income from a certain amount of securities (varying not with the fiduciary issue but with the excess of the notes and deposits over metallic reserve) should be paid over to the Treasury.[2] No action has been taken on these recommendations.

In a joint reservation to the Report Sir Thomas Allen and Mr. E. Bevin (representing respectively the Co-operative and the Trade Union Movements) made proposals, on the lines of the official Labour Party programme, as follows:

"From the point of view of popular confidence, which is so great an element in these matters, we are convinced that the Bank of England ought to be transformed into a public corporation. While it should remain free from political influence, its Governing body should not, even in form, be representative of private stockholders, nor should its membership be drawn very largely from one financial group. We think the minimum change required is the appointment of the Governors by the Crown, the establishment of an Advisory Council representing industry, commerce, etc., and the transformation of the stock into fixed-interest bonds." [3]

The Macmillan Committee reported in June 1931, and it is clear that up to that time there was little disposition to press the Labour Party's professed view as to the nationalisation of the Bank of England, since there was no substantial complaint about the actual working of the Bank. Most people would agree with Mr. Keynes, who said of Mr. Wise's proposals that it all seemed to

[1] Report of the Macmillan Committee, p. 119.
[2] *Ibid.*, p. 145. [3] *Ibid.*, p. 240.

him "dreadfully unreal," since in fact on the problems of the last ten years the Government and the Bank had been in complete accord, and the critics of deflation in the House of Commons had never had more than a small minority of votes.[1]

In the summer of 1931 the Labour Government had to take part in negotiations with the Bank of France and the Federal Reserve Board for credits to help the Bank of England to meet the withdrawals of foreign balances and maintain the gold standard. Balancing the budget was made a condition for these credits, and the Labour Government fell because it could not agree on a programme of economies and take the necessary urgent action. The National Government was formed. The Government and the Bank then obtained foreign credits, but these were not adequate to stop the run, and on September 21st, 1931, the gold standard was suspended. At the election shortly afterwards the opposition Labour Party was overwhelmingly defeated.

It was alleged that the bankers, American or British, had insisted that the Budget be balanced by cuts in unemployment pay and in the social services generally. According to one Labour politician, the electorate failed to realise that

> "the real issue . . . was whether the little ring of financiers who appoint the Governor and Court of the Bank of England, and who control the monetary policy of the country, was also to control the actions of the elected Government of the day through this same power and control over finance, or whether the elected Parliament and the Government depending upon it should be supreme." [2]

No doubt this complaint is very exaggerated. The Bank would only be doing its obvious duty in advising that the balancing of the Budget was urgently required to maintain the country's credit. However that may be, it is clear that hostility to the present organisation of the banking system has become firmly fixed in the mind of the

[1] Evidence before the Macmillan Committee, Qns. 7162 and 7201.
[2] J. M. Kenworthy, "Our Daily Pay," pp. 3, 46–9.

Labour Party. As Mr. G. D. H. Cole put it in October, 1931:

> "Labour is very angry with the bankers whom it regards as the chief source of the late Government's dissolution. . . . The crisis has brought the socialisation of banking from the background right into the forefront of the Labour programme, and has caused a somewhat lukewarm proposal for the nationalisation of the Bank of England to be converted into an urgent demand for full public ownership and control of the Joint Stock Banks as well." [1]

According to its latest proposals, the Labour Party would convert the Joint Stock Banks into a single public corporation, hoping to economise on buildings and Directors, and so to reduce the rates charged for advances.[2]

The nationalisation of the Bank of England would be, of course, in no way revolutionary. There is a good deal to be said on both sides, and the balance of advantage is purely a matter of opinion. How best to obtain independence for a Central Bank in ordinary working, together with adequate power for the Government to control the broad lines of policy without friction and delay, is a real problem. In the decade following the War the tendency was to try to strengthen the independence of the Central Banks to protect them against the demands of Governments with chronic deficits. To-day the desire to use monetary policy as a major weapon in the fight against world depression is causing a movement in many quarters towards more Government control. It is felt that the conservatism and orthodoxy of Central Banks may sometimes unduly obstruct the new policies that may be urgently required in the emergency.

Nobody desires that the Bank of England should be made a Government Department. If nationalisation should be carried through, it would be mainly a change of form, and need not involve more than a minimum of change in working arrangements. The most important thing about an institution is the spirit in which it is worked. It may be assumed that the public spirit and

[1] *The Economist*, London, October 17th, 1931.

[2] *Ibid.*, August 19th, 1933.

wide, disinterested views, that have prevailed for so long in the Bank, are likely to continue in spite of any change of form that may be made.

The nationalisation of commercial banking would be a really drastic change, as to which the pros and cons need not be argued here. One point that seems to have been overlooked is the nature of the relations that would exist between the proposed single huge commercial bank and the Bank of England. The functions of the Bank of England, as holder of clearing balances and the ultimate reserve, and as controller of the money market, could hardly continue in their present form. Logically it seems as though the Bank of England would have to be amalgamated with the Head Offices of the Joint Stock Banks in some way, so as to provide a new central organ for the whole unified system. One might say that the Bank of England would absorb all the other banks, or that it would disappear, according to the point of view!

As matters stand now, the position of the Bank of England has unfortunately become involved in active political controversy. The Labour Party's proposal to nationalise the Bank is in itself not of the first importance, and need cause no alarm of any kind. The nationalisation of commercial banking, however, would require a fundamental reorganisation, in which the Bank of England would necessarily be involved. In what shape it would emerge no one can possibly foretell, until the proposals are much more fully elaborated and co-ordinated. It will need very strong arguments to convince the British people that it is worth while to attempt far-reaching changes in institutions that on the whole have served them well in difficult times and are generally admired and envied throughout the world.

CHAPTER IV

THE UNITED STATES, (*a*) HISTORICAL

"DURING the early days immediately after the founding of the United States," says Professor Willis, "the view that close relations should be maintained between the government and a great central bank which should hold the public funds and receive and disburse them, was the accepted theory."[1] No doubt this was the accepted theory among people with real knowledge and experience of finance. Such men as Robert Morris and Alexander Hamilton aimed at creating a large semi-government bank similar in some ways to the Bank of England.

But banks have never yet won the same degree of public confidence in the United States as they have obtained in some countries, such as Great Britain and Canada. The general public in America, not without some show of reason, has been inclined to believe that bankers are by nature selfish, grasping and unprincipled. That a large, strong bank with special privileges and powers of control is bound to prove a dangerous and tyrannical monopoly and should not be permitted by a democratic people, has always been a widely accepted theory, at any rate until recent years.

The conflict between these two points of view runs all through the early history of the United States. Three times (in 1781, 1791 and 1817) a national Central Bank was set up at least in embryo, but failed to survive as such. The widespread hostility and suspicion towards large banks might not have been enough in themselves to bring these Central Banks to such untimely ends. Unfortunately, the opposition was greatly reinforced by the jealous feeling for "States' rights." Very effective

[1] H. Parker Willis, "American Banking," p. 306.

use was made of the doubt whether it was constitutional for the Federal Government to charter a bank, especially if it was to operate branches within the States. This, probably, was the decisive factor.

The Bank of North America at Philadelphia was chartered by Congress in 1781 at the request of Robert Morris, Superintendent of Finance from 1781 to 1784, and was "the first real American bank." [1] The Government subscribed $254,000 in specie, part of the proceeds of a loan from France; this was the bulk of the paid-in capital. During the last two years of the War of Independence, the Bank advanced altogether $1,272,842 to the Government in short-term loans. This did much to restore the public credit and make it possible to carry on the war to a successful conclusion.

> "As the treasury made a special effort to repay these loans in preference to other claims the practical result was the maintenance of a convenient working balance which the government could depend upon for immediate necessities." [2]

The loans were all repaid to the Bank in full by 1784, and after that it ceased to have any specially close relations with the Government. The Bank had many enemies in Pennsylvania, who regarded it as "the representative of an oppressive money power." [3] However, it conciliated the opposition, so that it was able to obtain a State charter from Pennsylvania in 1787 and continued to exist as an ordinary State bank.

Up to 1791, use was made of all the existing State banks for the holding of Government balances, except in so far as this money remained in the hands of the collectors of the revenue. Thus on December 31st, 1790, and June 30th, 1791, the Treasurer of the United States had something over $500,000 distributed amongst the three existing banks.[4] The bulk of this was shared by

[1] N. F. Hoggson, "Epochs in American Banking," pp. 49–62.

[2] D. R. Dewey, "Financial History of the United States," p. 55.

[3] *Ibid.*, p. 56.

[4] The Treasurer of the United States, "Accounts of Payments and Receipts, 1790–91," pp. 15, 35.

the Bank of North America and the Bank of New York. The third on the list was the Bank of Massachusetts (at Boston), which held only a small Government balance, perhaps because, unlike the others, it charged a commission for receiving deposits.[1] By September 30th, 1791, the Bank of Maryland (chartered in 1790 at Baltimore) had also become a depositary, and the total public deposits in the four banks came to about $680,000.[2] No security seems to have been taken from the depositaries at this time.

Alexander Hamilton, first and most eminent of the Secretaries of the Treasury, held office from 1789 to 1795, and the foundation of the First Bank of the United States in 1791 was largely his work. He had long been interested in banking, and made some suggestions to Morris before the Bank of North America was opened. In 1784 he took the lead in founding the Bank of New York, which was very helpful in making temporary loans to the Government. At one time he probably hoped to make this bank the sole fiscal agent of the Federal Government in New York.[3] But when Hamilton made his famous report to Congress in December 1790 recommending a strong National Bank,[4] he thought that a new institution with a larger capital was needed. The Bank of North America, having formerly been the National Bank in the years 1781–4, was given the option of reorganising on the desired lines. Very wisely, as things turned out, it preferred to stick to its own sound local business, though its President resigned and became the first President of the new Central Bank.

The First Bank of the United States received a charter for twenty years by Act of Congress in 1791, and opened for business at Philadelphia in December. The charter

[1] The Treasurer of the United States, "Accounts of Payments and Receipts, 1790–91," pp. 10, 14.

[2] J. M. Chapman, "Fiscal Functions of the Federal Reserve Banks," p. 5.

[3] J. T. Holdsworth, "The First Bank of the United States," pp. 12, 39.

[4] American State Papers, Finance, Vol. I, pp. 67–76.

was a good deal like that of the Bank of England in providing for Directors elected by the stockholders and strictly limiting the kinds of business to be done. The note issue was restricted by the rule that total liabilities (excluding deposits) should not exceed the capital, and the notes were made receivable in all payments to the United States. The chief difference from the Bank of England was the subscription of part of the capital by the Government. $2 millions out of $10 millions was the Government share, but it was set off against a loan of $2 millions at six per cent. from the Bank to the Government, repayable in ten annual instalments. Evidently this arrangement was meant to secure profits for the Government, and not control. There were no Government directors, and the Bank was forbidden to lend more than $100,000 to the United States without the previous permission of Congress. The private subscriptions were payable one-fourth in specie and the rest in United States stock.[1] This must have been a valuable support to the credit of the Government.

In its first few years the Bank lent large sums to the Government, since Congress was only too ready to follow the line of least resistance in raising funds. By 1796 the Government owed the Bank $6.2 millions, and there was a proposal to turn it into a funded debt. The Bank showed courage and independence in pressing for repayment on the ground that its funds were needed to support commerce and industry. Congress only provided for the repayment very gradually, and one unfortunate device used was the sale of the Bank stock held by the Government. This realised a premium of just over thirty-three per cent. on the average, but it would have been better to keep the stock and continue to draw the dividends, which averaged about eight and three-eighths per cent. per year.[2]

The Bank's charter did not mention public deposits, but it must have been the general intention that the Bank

[1] Holdsworth, pp. 19–24.

[2] *Ibid.*, pp. 42–49, and Dewey, "Financial History," p. 101.

should hold the bulk of the Government balances. This matter became

> "the subject of arrangement between the Treasury and the bank, and the benefit of the exclusive deposits, it is believed, was made the condition of the service of transferring the funds from place to place." [1]

This seems quite a sound arrangement, similar to the practice that had grown up in England of not paying interest on Government balances and not charging for services rendered in operating its accounts. The Bank of the United States claimed that the Government's account was unprofitable, because of the wide fluctuations of balances and the expense of making transfers. Some of the State banks at times expressed a strong desire to hold Government deposits on the same terms. Probably we may take it that the Bank made a fair profit from the use of these deposits in return for the work done.

In his Report on a National Bank, Hamilton doubted the wisdom of allowing the Central Bank to establish branches, but he thought provision might be made for its doing so later. The charter allowed the Directors to set up branches, and by 1804 eight branches had been opened in the principal cities of the country. It seems clear that Hamilton soon decided that all Government deposits should be kept with the Bank of the United States, except so far as depositaries might be needed in towns where it had no branch. The Federal revenue came chiefly from customs duties, and could be handled most easily by a Bank with branches in all the chief ports.

The existing deposits with State banks were not suddenly withdrawn, but gradually drawn down and not replenished. A table of Treasury balances in banks for each month in 1792 shows this process very clearly.[2]

[1] American State Papers, Finance, Vol. IV, p. 808.

[2] *Ibid.*, Vol. I, p. 214. Professor H. C. Adams is quite mistaken in saying that "there is no indication that the public bank had precedence over private banks in any matter that pertained to deposits or disbursements" of public money. ("Science of Finance," 1909 edition, p. 214.)

The Bank of Providence was the only State bank to receive fresh public deposits in the latter part of 1792, evidently because the Bank of the United States had no branch at Providence. By 1794 it was the only State bank still used as a depositary.[1] After that the number of State banks so used gradually rose with the need to extend facilities for Government business at places where the Central Bank had no branches.

The Government deposits in State banks, however, seem to have been comparatively very small, as long as the Bank of the United States existed.[2] During the period 1803–6 ten different State banks in all were used as Government depositaries, but only six to eight of them held balances simultaneously at the end of any one year.[3] Eleven State banks were acting as depositaries in 1811 out of eighty-eight then existing. The number rose sharply to twenty-one in the next year to make good the loss of the Bank of the United States and its eight branches.[4]

The fact that all Treasury balances, except "certain inconsiderable sums" for special purposes, were held by the Treasurer in banks, and not in his personal custody, was stressed in a report to the House of Representatives on Treasury procedure in 1794.[5] In the early years of the Bank of the United States the Treasury policy, according to Hamilton, was to keep an average cash balance of about $500,000 with it. This agrees with the monthly statement of public deposits for 1792. The specie balance with the Bank of the United States fluctuated between $200,000 and $700,000, and it also

[1] Finance Report, 1903, p. 22.

[2] Detailed figures for the years 1803–6 are in American State Papers, Finance, Vol. II, p. 218.

[3] *Ibid.* Professor Chapman, *op. cit.*, p. 8, gives sixteen State bank depositaries for 1804. This seems to be taken from the Table in Finance Report, 1903, p. 240, where it clearly includes the Bank of the United States and seven of its branches.

[4] Dewey, "Financial History," pp. 101, 127–8.

[5] Finance Report, 1903, p. 22.

held bills for collection which varied from nothing up to over $200,000.[1]

Hamilton was blamed by some for keeping too large deposits in the Bank, but quite unjustly. The size of the Government deposits increased greatly after his time. The end-of-the-year balances from 1803 to 1806 were between $4 millions and $5½ millions, of which the Bank of the United States held $3½ millions to $4½ millions. After that the total balances fell off again, and were below $2 millions at the end of 1810.[2]

These amounts were quite important in those days. The New York branch of the Bank of the United States held an average Government balance of well over a million dollars in 1803–6, when the total banking capital of New York was only $5 millions.[3] From 1800 all revenue bonds given by merchants for customs duties in the large ports were collected through the Bank of the United States, as that made the merchants anxious to pay in good time and maintain their credit with the banks. The Bank also made special arrangements to discount merchants' notes to help them pay these dues promptly. It was said that it was only the large revenue deposits from customs duties in the New York branch that enabled it to make advances more than twice as large as the capital allotted to it.[4]

Albert Gallatin, another very able Secretary of the Treasury (1801–13), was greatly impressed by the services of the Bank. He praised its readiness to advance loans to the Government, its help in collecting the customs revenue, its elastic and reliable bank-note circulation, and the safe-keeping and smooth transferring of Government funds.

"They place (he said) instantly our money where we may want it from one end of the Union to the other, which is done

[1] American State Papers, Finance, Vol. I, p. 214.

[2] Holdsworth, p. 60.

[3] Miss M. Myers in "The New York Money Market," ed. B. H. Beckhart, Vol. I, "Origins and Developments," p. 153.

[4] Holdsworth, pp. 62–5.

on the tacit condition of our leaving our deposits with them, and because if we shall be hard run and want money, to them we must apply for a loan." [1]

He showed that the Federal Government could obtain great advantages from a renewal of the charter, by requiring a lump-sum payment, or an agreement to pay three per cent. interest on Government deposits over $3 millions and to advance money to the Government at six per cent. on request up to a certain limit.[2]

It is a pity that other politicians did not follow this eminent financier's sound lead. Already in 1803 President Jefferson was "decidedly in favour of making all the banks Republican [*i.e.* Democratic in terms of to-day's party labels] by sharing deposits among them in proportion to the dispositions they show." He was also inclined to regard all banking as necessarily evil, because of its "supplanting the precious metals by a paper circulation." [3]

In 1810 President Madison did not oppose renewal of the Bank's charter. Gallatin strenuously advocated it, but just failed to carry the day. Thus the Bank had to close its doors in 1811. We are told that "in general the banks and the trade organisations of the country favoured renewal." [4] The personal jealousies and stupidity of many of the politicians, and the selfish interests of a few rival institutions, were chiefly to blame for the outcome. Of course, it is quite understandable that the holding of 18,000 out of 25,000 shares in the Bank by foreigners should arouse hostility, although persons living abroad had no voice in management.[5] The obvious remedy was to increase the capital by subscription at home and forbid sales to foreigners for the future. There can be nothing but keen regret now for the sabotage that ended this most useful and promising institution. It is safe to say that the damage then done to the national interests by stopping

[1] Adams, "Writings of Gallatin," Vol. I, p. 80, cited by Holdsworth, p. 68.

[2] Holdsworth, pp. 76–7.

[3] *Ibid.*, pp. 69–70.

[4] *Ibid.*, p. 83.

[5] Dewey, "Financial History," p. 127.

the smooth development of a sound and integrated banking structure is still being felt to-day.

The loss of the Bank of the United States was bitterly felt during the War of 1812–15. The Treasury had the greatest difficulty in getting subscriptions for loans; only $34 millions, measured in specie, was obtained from loans to a total of over $80 millions.[1] The policy of financing the War entirely by loans caused a general inflation, such that United States bonds depreciated by about forty per cent. and Treasury notes by about twenty-five per cent.[2]

The closing of the Central Bank in 1811 led to a boom in State banks, so that, whereas there were only 88 of them in all in that year, by 1816 they had increased to 246. At first it was thought that they might prove satisfactory bankers for the Federal Government, but before long their palpable shortcomings led to a general desire for a new Central Bank. The notes issued by the various State banks depreciated through over-issue by 1815 to an extent varying from twenty to fifty per cent. All the banks except those of New England suspended specie payments in 1814. At that time there were Government deposits in nearly a hundred of them to a total amount of about $9 millions.[3]

> "The direct loss to the Government (says Professor Dewey) from poor or worthless bank-notes received during the four years 1814–1817, amounted to over $5,000,000. The monetary derangement was so acute that the Treasury department was obliged to keep four accounts with its depositaries in four standards of value: cash or local currency; treasury notes bearing interest; treasury notes not bearing interest; and special deposits." [4]

These "special deposits" were deposits of notes of banks which were not paying specie; they had to be kept unused until specie payments should be resumed. At times the Treasury was unable to meet its obligations on the

[1] Dewey, "Financial History," p. 134.
[2] R. C. H. Catterall, "Second Bank of the United States," p. 5.
[3] D. Kinley, "The Independent Treasury," p. 16.
[4] Dewey, "Financial History," pp. 144–5.

national debt through the great difficulty in obtaining specie or transferring its funds, and was hard pressed to find any means of making even the smallest current payments.[1]

From 1814 proposals were constantly being made for a new Central Bank, but there were bitter contests over the details. Finally in 1816 the Act chartering the Second Bank of the United States was carried, and the Bank opened in Philadelphia in January 1817. Many of the provisions of the charter as to the note-issue, the business permitted and the general organisation were the same as for the First Bank of the United States.[2] This time the capital was fixed at \$35 millions, of which the Government subscribed one-fifth in five per cent. stock; the remaining \$28 millions was raised by private subscriptions payable as to three-fourths in Government stock and one quarter only in specie. As with the First Bank, Government stock could be sold but not bought. Loans to the United States were limited to \$500,000 unless authorised by law.

Of the twenty-five Directors five were to be Government Directors appointed by the President with the approval of the Senate. Weekly accounts were to be rendered to the Treasury, and either House of Congress might investigate the books through a Committee. A payment of \$1½ millions was exacted for the charter. Definite provision was made in Section 16 of the Act for the Federal Government's deposits to be placed with the Bank, "unless the Secretary of the Treasury shall at any time otherwise order" and report his reasons to Congress. This new provision was due to the difficulties experienced in keeping Government deposits in the State banks. The intention probably was that the Federal Government should try to avoid making any use of the State banks as depositaries in future, but this was not found feasible.

[1] Catterall, pp. 6–7, and Myers, pp. 155–8.

[2] Dewey's "The Second United States Bank" gives a comparison of the two charters item by item on pp. 163–75.

The Bank was very successful in 1817 in helping the Secretary of the Treasury to get the State banks to resume specie payments. Unfortunately, however, the first President, William Jones, turned out to be very weak and careless. Loans were made against the Bank's own stock, and there was improper speculation in it by Directors. Serious malpractices, especially in the Baltimore branch, were not detected in time, and caused large losses. The Bank also followed an inflationary policy that led up to a commercial crisis in 1819. Under the administration of Langdon Cheves, 1819–23, the position was retrieved. After 1823 Nicholas Biddle made the Bank "the most powerful and best-managed financial institution the country had ever seen."[1]

At the beginning of 1817 the Treasury had about $15 millions deposited in ninety-four State banks. About $3 millions of this was in "special deposits" of depreciated bank-notes, and another $3 millions was in depreciated Treasury notes.[2] The State banks naturally did not relish paying over these deposits to the Bank of the United States, though the latter tried to make suitable arrangements for transferring them gradually. As specie payments had nominally been resumed, all the Government deposits, including "special deposits," should have been paid over in specie on demand, but many of the State banks had locked up too much of their funds in investments not easily realisable, and were in no position to pay quickly. The Government saddled the Bank with the difficult and unpleasant task of insisting on payment. By the end of 1818 it had collected the bulk of the special deposits in cash. The task was completed some time later, but not without incurring the bitter and lasting hostility of some of the State banks.[3]

Another great dispute arose as to the acceptance of State bank-notes by the Bank in current payments. At first such notes were freely received, but the Bank found

[1] H. P. Willis, "American Banking" (1918 edition), p. 210.

[2] Myers, p. 159.

[3] Catterall, pp. 26–7, 456–7. Dewey, "Second U.S. Bank," pp. 181-8.

that it did not pay, and changed its policy in 1818. The Treasury tried to insist on the Bank's receiving such notes in current payments for Government account and to make the Bank bear all the risk of loss, which was very unfair. A fair arrangement was made in 1820, by which the Bank received State bank-notes in payments to the Government and credited the Treasury at once, on condition that the amount of any note not paid by the issuing bank on presentation would be debited to the Treasury. But disputes over redemption of notes continued to cause ill-will between the State banks and the Bank of the United States.[1]

The Second Bank of the United States built up a system of twenty-six branches, of which eighteen were opened in 1817. But it was still found necessary to use State banks to receive Government revenues and to disburse Government pensions and debt payments where the Bank of the United States had no branch. The Bank was asked to select its own agents for these purposes from among the State banks, and to keep a consolidated account of the Government's transactions and transfer funds when necessary. Thus the Treasury had no direct relations with the State bank depositaries, except that they sent weekly reports of receipts to be checked against the accounts furnished by collectors. By October 1817 thirty-four State banks had been chosen to act as depositaries in this way.

This arrangement foreshadowed in a remarkable way what was to happen a hundred years later, when the ordinary banks were to be used as depositaries under the supervision of the Federal Reserve Banks. Unfortunately, it broke down through the unreasonableness of the Treasury in holding the Central Bank responsible for any loss of the Government money in the State banks. The Treasury also expected to be able to draw drafts on any depositary up to the full amount of its balance on the Central Bank's books, without giving the Bank enough notice to enable it to transfer funds if necessary.

[1] Catterall, pp. 454–6. Dewey, "Second U.S. Bank," pp. 188–94.

Direct relations were restored in 1818 between the Treasury and the State bank depositaries, each with its separate account. In 1819 the Treasury also agreed that its account should be kept separately with each branch of the Bank of the United States. Time was to be given on an agreed scale to effect the necessary transfer of funds, whenever the Treasury wished to draw against a branch for more than its balance there.[1]

The Bank started several of its branches at the request of the Treasury, solely to facilitate Government business in places where the State bank depositaries were unsatisfactory. But even then the latter could not be dispensed with altogether. In October 1833 there were still thirteen State banks holding funds and making payments for the Government.[2]

The average amount of Government deposits held by the Bank of the United States from 1819 to 1833 worked out at $6,717,253. This fluctuated greatly, and varied from about $2½ millions to nearly $25 millions in the half-yearly statements over the period 1817–33. At the same time, other deposits grew gradually from about $1 million to nearly $10 millions, and the note circulation of the Bank from about $2 millions to $20 millions. At most times public deposits were larger than other deposits; they were clearly a very important part of the Bank's resources, and its use of them without payment aroused much jealousy.[3] Gallatin's proposal of 1809 to make the Central Bank pay interest on public deposits over a certain figure should have been put into the Act of 1817. The question of interest was raised again in 1828, but nothing could be done without violating the charter.[4]

Experience showed that the Government ran a great risk in leaving its funds with the State banks, which were governed by varying State laws, and were in no way amenable to supervision by the Federal Government. In the period 1817–34 about $1¾ millions of Government

[1] Catterall, pp. 460–63. [2] *Ibid.*, pp. 461–2.
[3] *Ibid.*, pp. 475, 503. [4] Dewey, "Second U.S. Bank," p. 215.

money became unavailable through the failure of State banks, and nearly $1 million of this was still outstanding in 1834. By 1841 the total loss from State banks, including principal and interest, had risen to nearly $15½ millions.[1] The Central Bank, on the other hand, never lost a penny of the Government's money, and was obviously far safer.

One Secretary of the Treasury gave an excellent summary of the services of the Second Bank of the United States as follows:

> "First, that it enabled the treasury to apply the public funds at the proper moment to every part of the country; second, that its stock served as a remittance abroad; third, that by discounting government stock it enabled the public debt to be reduced gradually; and fourth, that the public funds were safer than they had been before."[2]

The third service mentioned here is particularly interesting. When a large amount of Government securities had to be redeemed, the Bank would make advances on the stock to a gradually increasing extent beforehand, thus avoiding the disturbance to the money market that would be involved in drawing out the funds to make payment and then suddenly throwing them back again in one huge amount.[3] In this way the Bank was performing the service expected of a modern Central Bank in smoothing out the effects of Treasury operations on the money market, and something very similar to what, as we have already seen, the Bank of England began to do in 1829 with its "quarterly advances."

The "Bank War" of 1833–6 between President Andrew Jackson and the Second Bank of the United

[1] Catterall, p. 462, note 1, and p. 464.

[2] Myers, p. 161. It is worth noting that this list does not refer at all to borrowing by the Government. The whole of the period 1817–36 was one of peace, and the Government had little need to borrow. But the Bank made some short-term advances to the Government, and also arranged for some small long-term loans on good terms; its lending power would have been most useful in any emergency. See Catterall, p. 471.

[3] Catterall, p. 472.

States is an extraordinary episode which we can only just mention. If history ever taught a clear lesson, surely it was that the closing of the First Bank of the United States was a mistake. But the President looked further off for his lesson from history. "Ever since," says he, "I read the history of the South Sea Bubble I have been afraid of banks."[1] Having himself "the mental processes . . . of the average honest, ignorant man,"[2] together with unyielding obstinacy and great personal popularity, he was able to destroy the Bank in spite of strong opposition from Congress and his own Cabinet. In 1832 he vetoed the renewal of the Bank's charter, and then won the Presidential election on that issue. In September 1833 he even ordered the removal of the Government deposits from the Bank, though Congressional Committees had decided that they were perfectly safe with the Bank and experience showed conclusively that they were far from safe with the State banks.

Large drafts on the Bank by the Treasury for about $1,300,000 were given to certain State banks without notice to the Bank, and the proceeds were used by these State banks to support inflationary loan policies. The rest of the public deposits, amounting to about $8½ millions, was gradually used up over the years 1833–6 in payments by the Government, whilst no new public deposits were placed with the Bank of the United States.[3] With the expiry of its charter in 1836, the Bank ceased to function as a national institution.

Jackson asserted that the Bank meddled in politics, but the charge was not justified. "Until a political attack had been made upon it the central management of the bank kept itself singularly free from political activity."[4] No doubt Nicholas Biddle was a masterful and rather tactless person and there were some faults on his side. But these personal questions were trivial compared with the general principle, as to which the following verdict by Professor Catterall seems to be inescapable.

[1] Catterall, p. 184. [2] *Ibid.*, p. 296.
[3] Myers, p. 162. [4] Dewey, "Second U.S. Bank," p. 258.

"Up to the period of the Bank War the connection between the Bank and the Government was an immense benefit to both, but particularly to the Government. . . . The Bank would have been progressively useful. . . . It becomes obvious that Jackson and his supporters committed an offence against the nation when they destroyed the Bank." [1]

From 1833 the depositing of public funds in the State banks, and the removal of the Central Bank's check on the note issues of the State banks, helped to produce a large increase in the number of State banks, and an inordinate inflation of both notes and discounts, just as in 1811–16. This was the time of "wild-cat banking." The number of State banks rose from 330 to 788, and their note issues increased by about two hundred per cent., between 1830 and 1837.[2] The number of State bank depositaries naturally increased in 1833, as fresh depositaries were needed in cities where the Bank of the United States had been doing the work. On December 31st, 1836, the Treasury had over $45 millions in bank deposits, and ninety-one banks were used as depositaries in that year.[3] Nearly all of these must have been State banks, though the Bank of the United States still held a small remnant of its public deposits, amounting to $324,000, in March 1836.[4]

The State bank depositaries were directly encouraged by a Treasury circular of 1833 to regard their Government deposits as semi-permanent and to make use of them to extend their loans considerably.[5] When the Govern-

[1] Catterall, p. 47.

[2] A. B. Hepburn, "A History of Currency in the United States," pp. 122, 131. Dewey, "Financial History," p. 225.

[3] Finance Report, 1913, p. 276. The figures for depositary banks in this list no doubt include the Bank of the United States and those of its branches which had public deposits for the years 1817–36. This is not allowed for by Professor Chapman ("Fiscal Functions of the Federal Reserve Banks," p. 18). Moreover, the omission of figures for 1817 and 1819–21 cannot mean, as he implies, that no State banks were used then, but only that the correct numbers were not ascertained.

[4] Catterall, p. 503.

[5] D. Kinley, "The Independent Treasury," p. 29.

ment became alarmed by the extent of the inflation, it issued the drastic "specie circular" of July 1836 forbidding the receipt of any bank-notes whatever in payments for public land. At the same time, Congress ordered the distribution of the bulk of the Federal Government's surplus to the States in four payments, nominally on deposit, but really as a gift. Three of the payments were made in 1837 in spite of a serious transfer problem, and "to this day the money thus deposited stands on the books of the treasury as unavailable funds, $28,101,644."[1] These measures enforced a severe contraction by the banks, leading up to an extreme financial panic in 1837. The deliberate destruction of the Central Bank very quickly brought its own nemesis.

In earlier years it was a common practice for the Treasury to assist such banks as it thought deserving in times of special difficulty, by making deposits with them in order to support their credit.[2] Such transfers were strictly forbidden by an Act of June 1836 regulating the holding of Government deposits by the State banks. This shows the growth of the idea that the Treasury should hold itself aloof from banks. It is also significant that from 1836 the end-of-the-year figures begin to show considerable balances held in the Treasury itself. This had been almost unknown before; before 1836, only negligible sums are shown as so held in two of the years from the time when the Treasury came into existence, and nothing in all the other years.[3]

The depositary banks under the Act of 1836 were to be selected by the Secretary of the Treasury, and this inevitably led to charges of favouritism and political influence. The cry of "pet banks" has been common in the United States when the placing of Government deposits in banks has been at the discretion of Government officials who are subject to pressure on behalf of particular

[1] Dewey, "Financial History," p. 221.

[2] See Myers, p. 153, for an example in 1801, and also p. 154 (1813) and p. 160 (1817 and 1819).

[3] Finance Report, 1913, p. 276.

institutions. Such complaints seem to have been very well founded in the years following this Act. No bank was to hold Government deposits exceeding seventy-five per cent. of its capital, and on any amount exceeding twenty-five per cent. of its capital interest was to be paid at two per cent. per annum. These provisions do not seem to have been strictly enforced.[1]

History repeated itself in the grave difficulties that soon beset the Treasury after the closing of the Second Bank of the United States, just as had happened after the closing of its predecessor. In 1837 most of the banks suspended specie payments and many of them failed. About $11 millions was due to the Government from insolvent banks in 1838, and approximately $2.4 millions more from banks that had suspended specie payments in the previous year.[2]

Considerable effort was made by the Whig party to get a Central Bank established again. But a series of misfortunes, that happened when they came into power, caused all their attempts to fail. Among the Democrats the movement for an Independent Treasury, as the only means of ensuring safety for the Government's balances, continued to gather way. It was clear that the State banks were decidedly unsatisfactory. After the collapse of 1837 the bulk of the public funds was kept in the hands of collectors, until ordered to be paid out. This was contrary to the Act of 1836, but it proved fortunate when the banks broke down again in 1839.[3]

The Independent Treasury was first established by an Act of 1840, which, however, was not strictly carried out. In 1841 that law was repealed, and a fresh arrangement was made for State bank depositaries on rather different lines from the Act of 1836. Collateral security was to be given by every bank for the amount by which its

[1] See Myers, p. 171, for a case of a bank still holding more than the legal amount in 1837. According to Finance Report, 1913, p. 5 : "Prior to 1908 interest had never been required on Government deposits."

[2] Chapman, p. 24.

[3] Kinley, pp. 39, 47.

Government deposits exceeded half its paid-up capital.[1] This seems to be the first appearance of the requirement of security for Government deposits, which practically makes the Government to that extent a preferred creditor.

The State banks gave comparatively little cause for complaint in the period 1841–6. The long controversy dragged on until in 1846 the Independent Treasury was finally and rigidly established. No public funds were to be deposited in any bank. All must be kept in coin in the Treasury and sub-treasuries, or retained by the public officers receiving them until paid out on proper authority. No bank-notes whatever were to be received in payments to the Government. For some time there really was, as intended, a complete divorce of the Government's balances and financial transactions from all banking operations. Professor Kinley considers that this arrangement was "justifiable and necessary" at that time, in order to protect the Government from the dangers and losses involved in using the unreliable notes of the State banks.[2] Presumably he holds that the re-establishment of a Central Bank was not then possible. Since the First and Second Banks of the United States managed the Government's business satisfactorily and without any losses whatever, it seems fairly certain that another Central Bank would have been decidedly preferable to the Independent Treasury.

The flow of revenue should just balance the flow of public expenditure if an Independent Treasury system is to work smoothly; unless both flows are fairly steady, dislocation is sure to arise. An excess of expenditure means that the Treasury must borrow, and so will tend to lose its independence of the financial institutions of the country, and affect the general credit structure. An excess of income means that the surplus is drawn into the Treasury in cash, so that the cash basis for the rest of the community's business is correspondingly reduced. If the Treasury cannot keep a constant balance between income and outgo, its operations must have some effects

[1] Myers, pp. 180–81. [2] Kinley, p. 52.

on the banks and the money market. Naturally the Treasury will try to avoid influencing them adversely, and it is easy to see that it will probably be led almost insensibly to undertake some of the functions of control usually exercised by a Central Bank.

In the United States there was no likelihood of such a balance in public transactions as would enable the Treasury to remain truly independent. Income and expenditure were controlled by separate Committees of Congress with little regard for harmony; also the most important part of the revenue was the highly fluctuating yield of the import duties. Nevertheless, the Independent Treasury system worked without any insuperable difficulty over the prosperous period of 1846–61. The borrowing required for the Mexican War in 1847 was moderate. The Treasury was able to raise sufficient funds directly from the public and not through the banks. After the War the tendency for surpluses to accumulate was countered by getting permission from Congress to buy Government bonds at the market price (above par) and by repaying various Government obligations.[1]

Mr. Guthrie, Secretary of the Treasury, stated in 1856 that if there had been no public debt to make it possible to put the surplus revenue back into circulation "the accumulated sum would have acted fatally on the banks and on trade." He had quite given up the idea of absolute separation of the Treasury from the banks and from business generally. On the contrary, he was inclined to regard the Treasury as performing what we should now call central banking functions in an attempt to iron out the business cycle!

> "The independent treasury (he says), when overtrading takes place, gradually fills its vaults, withdraws the deposits, and, pressing the banks, the merchants, and the dealers, exercises that temperate and timely control which serves to secure the fortunes of individuals and preserve the general prosperity."[2]

This offers a strange contrast to the ideas of those who

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[1] Myers, pp. 188–9.

[2] Finance Report, 1856, p. 32.

founded the Independent Treasury, and a remarkable anticipation of the doctrines and practice of Secretary Shaw some fifty years later. Thus the separation of the Treasury from the money market was first modified by the desire not to injure business by hoarding specie, and by 1856 there had emerged the idea of controlling the money market by varying the size of the Government's hoard.

Between 1853 and 1856 over $45 millions of Government stock was redeemed, but this was not enough to prevent the accumulation of funds in the Treasury. By March 1857 the Treasury balances reached a high point of $21 millions, and were not greatly reduced until after the financial panic of that year began in August. Meanwhile the specie held by the New York city banks fell from about $17 millions in 1855 to about $8 millions in 1857.[1] A careful student of the contemporary literature holds that the Independent Treasury contributed to the feelings of "uncertainty and dread" which led up to the crisis, and that it exhibited a "lack of flexibility" compared with the Bank of the United States.[2] Whatever may be thought of the theory of credit control behind Secretary Guthrie's ideas as to regulating the money market, it is clear that the Independent Treasury was not a suitable or efficient machine for any such purpose.

The problem of the surpluses in the years 1848–57 thus caused the Independent Treasury law to be worked in a very different spirit from what was originally intended. But the first actual breakdown in the system and consequent changes in the law came from the opposite trouble, excess of expenditure. The Civil War broke out in 1861, and it became necessary to raise large loans from and through the banks. The Government also made large issues of its demand notes which circulated as currency. Congress modified the Independent Treasury Act so as to permit leaving the proceeds of loans on deposit with the banks, but Secretary Chase insisted on immediate payment in specie. At the end of 1861 the banks had to

[1] Myers, p. 191. [2] *Ibid.*, p. 193.

suspend specie payments; the Treasury was forced to follow suit, and its notes (" green-backs ") were made legal tender, so that the war might be financed largely by inflation. Customs duties were still to be paid in gold, to enable the Government to pay the interest on the national debt in gold. With that exception, the Treasury was on an inconvertible paper basis until 1879.

Congress established the system of National Banks by Acts of 1863 and 1864 mainly to provide a bank-note currency more reliable than that of the State banks, and to assist the market for Government bonds, which were to be held as security against the notes of National Banks. These banks, of course, were purely commercial banks, though chartered under Federal authority, and were never intended or expected to perform any central banking functions. However, the Act of 1864 authorised the Secretary of the Treasury to use the National Banks as depositaries for Government revenue other than customs revenue on taking security by " the deposit of United States bonds and otherwise." Proceeds of loans during the War were left on deposit with the National Banks and gradually transferred to the Treasury. Much use was also made of these banks for a few years after the War, as it was found desirable not to withdraw suddenly from the banking system the large sums raised by heavy loans and taxes.[1] In 1868 it was suggested that the Treasury had " despotic control " over the banking system through its power to reduce the banks' legal tender reserves by selling gold, selling bonds and drawing on its deposits with the National Banks.[2]

There can be little doubt that the Independent Treasury should have been abandoned when it broke down during the Civil War. Unfortunately the old prejudices against banks survived to such an extent that the legal framework of the Independent Treasury was retained with a minimum of change. Within a few years of the War, it had very largely resumed its previous position and functions.

[1] A. P. Andrew in *Quarterly Journal of Economics*, Vol. XXI, p. 524.
[2] Kinley, p. 114.

Of course some balances continued to be kept in National Banks under the Act of 1864. In fact, the years 1847–63 are the only ones in the whole history of the U.S. Treasury when it had no funds in depositary banks at the end of the financial year. But while on June 30th, 1867, there were Government deposits in 385 National Banks, after that the number declined rapidly to 148 in 1870, and then to a minimum figure of 124 in 1878. Not until 1900 were there again as many banks holding Government money as in 1867. The end-of-the-year balances over the whole period from 1868 to 1899 show that the great bulk of the Government's money was kept by the Treasury and the sub-treasuries. Only very limited use was made of the National Banks, with the one notable exception of the year 1879, when the banks held large Government deposits for a short time in connection with the refunding of Government bonds and the resumption of specie payments.[1] From time to time Congress extended the permission given to use the National Banks as custodians of public money, but never made such use compulsory. Discretion in the matter remained with the Administration, and was " surrounded with abundant and, in cases, humiliating safeguards." [2]

In the period 1879–90 the problem of dealing with the Treasury surplus again caused constant perplexity. No method was evolved for dealing with it beyond the old one of buying up Government bonds. Government deposits in the National Banks were increased from under $20 millions to $60 millions in 1887 as a result of increasing the maximum for any one bank from $500,000 to $1 million, and somewhat relaxing the Treasury regulations as to Government bond collateral. This increase in Government bank deposits was found to involve a contraction of the notes issued by National Banks, since these also had to be backed by Government bonds, and the supply of the latter available with National Banks was

[1] Finance Report, 1913, p. 277.

[2] M. S. Wildman in *Annals of the American Academy of the Political and Social Sciences*, Vol 36, p. 575.

limited. Government deposits in banks were therefore gradually brought back to their old level in the course of a few years.[1]

Deficits gave continual trouble again between 1890 and 1898. Loans had to be raised from banks in 1895 and 1896 to help the Treasury to maintain the gold standard. The proceeds were left with the banks for some time, and gradually removed into the Treasury. The same procedure was followed when loans were raised for the Spanish-American War in 1898.[2]

The surplus problem was again dominant from 1899 to 1913. Buying Government securities could not dispose of it, since most of them had been " refunded " at a low rate of interest and were being used to back National Bank-notes. It has been said that under the Independent Treasury system one of the chief functions of the Secretary of the Treasury was " the task of technical obedience to the law without permitting its hostile spirit to endanger the stability of the money market." [3] There was hardly even technical obedience to the law in the last period, especially in the time of Secretary Shaw, 1902–7. The gradual modification of the Independent Treasury system so as to permit co-operation with the New York money market by " extra-legal and sometimes illegal transactions," [4] was going on to some extent from 1863. It was greatly accelerated from about 1898, and the Secretary of the Treasury definitely assumed the function of " guardian of the money market."

By this time there was very general dissatisfaction with the working of the Independent Treasury, chiefly on the ground that it withdrew cash from business uses at the busiest time of the year in the autumn, and returned it largely in the dull seasons by payment of interest on the public debt in January and July.[5] It is certainly " true that under the Independent Treasury system . . . the receiving and disbursing of a billion dollars in the course

[1] Myers, pp. 370–71. Finance Report, 1913, p. 277.
[2] *Ibid.*, pp. 380–81.
[3] *Ibid.*, p. 391.
[4] *Ibid.*, p. 353.
[5] Chapman, pp. 38–9.

of a single year caused considerably more disturbance to business than a turnover of several times that amount" in more recent years.[1]

Secretary Gage began in 1898 the policy of allowing Government deposits to accumulate in National Banks in the autumn, in order to relieve the seasonal stringency due to the need for extra funds to help move the crops. His view was that the United States ought to have a Central Bank of some sort to regulate its banking system and money market. But since there was no Central Bank, he thought the Independent Treasury should try to perform the same functions, though it could only do so "in a crude way."[2]

Secretary Shaw, the next Treasury head (1902–7), was a bold innovator. When the law hampered his attempts to relieve or control the money market, he did not hesitate to ignore precedents and act on new interpretations.[3] In 1902 he decided to accept, when he saw fit, other bonds, such as State and municipal bonds, in place of the United States bonds by which the law required Government deposits to be secured. He also informed the National Banks that their Government deposits could be excluded from the deposits against which their proportionate reserves were to be held in the form of cash in vault or deposits with other banks. Of course the requirement of the usual reserves in addition to full cover by Government bonds was excessive. The best course would have been for Congress to abolish the bond cover and retain the reserve requirements. Secretary Shaw had suggested this, but no action was taken.[4]

Another big change in Treasury practice took place in 1903, when Secretary Shaw ruled that he had power to transfer funds already in the Treasury to the depositary

[1] H. P. Willis, "The Federal Reserve System," p. 28.

[2] Article by ex-Secretary Gage in the *American Economic Association Quarterly*, April 1908, pp. 212–17.

[3] Article by A. P. Andrew, *Quarterly Journal of Economics*, Vol. XXI (August 1907), pp. 519–66.

[4] Finance Report, 1902, p. 62.

National Banks. Until then it was supposed that the only lawful way of getting Government funds into the banks was to allow payments of internal revenue to be made at the banks. That method had only allowed Government funds to accumulate in the banks at a rate limited to about \$500,000 a day.

In 1906 deposits were made with National Banks that undertook to import gold, in order to encourage the import of gold by preventing any loss of interest during transit. Funds were also deliberately accumulated in the Treasury and then deposited with banks in September on agreements for repayment at fixed dates. The object was to produce an expansion and contraction of bank deposits according to seasonal needs. An attempt was also made to give similar elasticity to the issue of National Bank-notes by allowing other securities temporarily to replace Government bonds as cover for deposits, thus releasing Government bonds to back extra notes during the stringency and recalling them to back the deposits when it was time to contract the note circulation.

There was much controversy over Secretary Shaw's policies, but on the whole public opinion was not very hostile. Most people agreed that the Independent Treasury was a bad arrangement, and looked to the Secretary of the Treasury to do his best to promote the smooth working of the money market for want of any other central authority. Secretary Shaw, however, was so pleased with his innovations and experiments that by 1906 he had convinced himself that no other central authority was needed. He was more confident and far more rash with his promises than Peel was at the time of the Bank Charter Act of 1844 in England. The Secretary of the Treasury, he maintained, should be empowered in his own discretion (1) to alter the reserve requirements of National Banks, (2) to control the total circulation of National Bank-notes, and (3) to control \$100 millions of Government money to be deposited in the banks or withdrawn into the Treasury as he thought fit. With these powers in his hands he would undertake

to keep not only the United States, but the whole world, free from panics in future.[1]

Just as Secretary Guthrie's optimistic view of the capacity of the Independent Treasury to perform central banking functions in 1856 was followed at once by a severe crisis that seemed to demonstrate the reverse, so also the rather naïve prognostications of Secretary Shaw were followed in the very next year, 1907, by a major banking crisis. Secretary Cortelyou tried to help by depositing Government money in the National Banks as far as possible, but Government relief was not found to be very effective. The panic had to run its course, mitigated by such action as the banks could take to help one another.[2] Nothing more was heard of Secretary Shaw's advocacy of Treasury control as a panacea.

When Secretary Gage began to increase considerably the amount of Government money in the National Banks from 1898, he disregarded the old limit of $1 million for any one bank, and allowed large amounts to accumulate with the National Banks in New York City. The National City Bank alone sometimes held over $20 millions, as other banks were not able to furnish the necessary collateral.[3] Of course this led to constant charges of favouritism. In 1901 Congress therefore passed an Act requiring the Secretary of the Treasury to "distribute the deposits herein provided for, so far as practicable, equitably between the different States and sections." This, together with Secretary Shaw's practice from 1903 of transferring funds from the Treasury to banks, opened the way for the creation of a class of "special depositaries" with "inactive accounts," which were practically Government loans. These were first extensively used during the 1907 panic.[4] Such banks did not perform any transactions for the Government, but simply held, until called for, deposits of whatever funds the Treasury saw fit to transfer to them. There were over

[1] Finance Report, 1906, pp. 46–9.
[2] Willis, "Federal Reserve System," pp. 35–6.
[3] Kinley, p. 122, and Myers, p. 383.
[4] Kinley, p. 129.

1,000 National Banks in use as special depositaries in 1908, but the number fell to 608 by 1916. Meanwhile the number of National Banks acting as "regular depositaries" increased, so that the total number of depositaries remained fairly steady, ranging between 1350 and 1600 in the period 1908–16.[1] It is asserted that many of the depositaries were "pet banks," in that they received deposits for political reasons owing to pressure on members of Congress by their constituents.[2]

On June 30th, 1913, there were 698 special depositaries holding only about $1½ millions in all, while the total Government balances in National Banks were nearly $70 millions. The distribution of special deposits by States indicates that 693 National Banks in the States held $1,000 each, while five National Banks in the District of Columbia held a total of $880,000.[3] In the autumn of 1913 special "crop-moving deposits" were also made with the special depositaries to a total of over $37 millions, to be returned in four instalments. A similar policy was followed in the autumn of 1914, when all National Banks were asked to state their requirements; a sum of $37 millions was allotted to meet them, and about $23 millions was actually drawn out by the banks.[4]

The Aldrich–Vreeland Act of 1908 is best known for its temporary provision of a means for creating emergency currency in future times of crisis. It also laid down rules for the payment of interest by National Bank depositaries on their Government deposits. Interest was to be paid in future "on the entire amount held by temporary or special depositaries and on the amount held by the regular depositaries in excess of the amount needed for the transaction of public business" as fixed by the Secretary of the Treasury.[5] The rate of interest was also to be fixed by the Treasury. From June 15th, 1908, it was

[1] See list in Table III on p. 200.
[2] Willis, "Federal Reserve System," p. 29, and Chapman, p. 47.
[3] Finance Report, 1913, p. 286.
[4] *Ibid.*, 1914, pp. 25–6, and 1915, p. 13.
[5] *Ibid.*, 1908, p. 46.

one per cent., but it was raised to two per cent. as from June 1st, 1913.[1] The rate was uniform for the whole country, ignoring the wide variations in market rates of interest between different parts of the country. At the higher rate imposed in 1913 country banks were still glad to get Government deposits, but the New York banks thought it unreasonable in view of the work they did for the Government.[2]

Writing in 1910, Professor Kinley was of opinion that the Independent Treasury law had been "repealed piecemeal," because "the separation of the Treasury and the banks . . . was felt to be injurious to the business of the country."[3] As Professor Adams has said: "The independence of a public treasury is a policy that cannot be maintained except in the most formal and superficial manner."[4] From about 1898 there was no pretence of keeping up even the formal independence of the U.S. Treasury. When an Act of 1907 permitted customs revenue, like other receipts, to be paid into National Bank depositaries, no legal bar remained to holding practically all the Government balances in banks. But they still had to be withdrawn into the Treasury before they could be used for disbursements. The Treasury would be entirely free from any legal compulsion to keep itself separate from the banks, if only it were now empowered to operate on its bank accounts by cheques, like any other holder of a bank account.

It cannot be said, however, that the system which grew up in the period 1898–1913 of increasingly close relations between the Treasury and depositary National Banks was much more satisfactory than the Independent Treasury itself in its original form. Though efforts were made to distribute Government funds equitably throughout the country, the amounts allotted to country banks often resulted merely in deposits by them with city corre-

[1] Finance Report, 1914, p. 25.
[2] *The Bankers' Magazine*, New York, 1913, p. 675.
[3] Kinley, p. 207.
[4] H. C. Adams, "Science of Finance," p. 218.

spondents, which were used in loans to the stock market.[1] Thus an increase in Government deposits was liable to encourage stock-market speculation, and the Treasury did not seem to be able to prevent this. This is only one indication of the fact that the Treasury could never hope to be in such a close and organic relation with the banks as to be a proper instrument for control over their general credit policy.

The practice of making Government deposits in order to help out particular banks in difficulties, or as with " crop-moving deposits " to assist certain sections of the community, led to undue reliance on this kind of help. This was perhaps one cause of the 1907 crisis, as it contributed to the over-extension of credit by some banks and consequent speculation. No doubt such uses of Government deposits also encouraged political pressure by special interests for assistance in other similar ways. A notable example is the persistent demand for Government-aided farm credit.[2]

The Secretary of the Treasury could hardly be expected to handle Government deposits very satisfactorily whilst he was subjected to constant political influence in regard to their distribution. Nor would he as a rule be likely to have the technical knowledge needed to control the money market wisely. The means at his disposal, too, were not suitable for exercising a smooth control. Transfers of funds from the banks to the Treasury were made by " calls " for arbitrary amounts at times fixed by the Secretary. The calls could not be foreseen with any certainty, and the expectation of a call often disturbed the stock and money markets.[3]

From 1907 there was general agreement that some far-reaching measure of reform was required, and that the " Treasury deposit system . . . was at length bankrupt in practice as it had always been in principle." [4] No

[1] Finance Report, 1908, p. 161.
[2] Willis, " Federal Reserve System," p. 30.
[3] M. S. Wildman, *loc. cit.*, p. 580.
[4] Willis, *op. cit.*, p. 36.

satisfactory way of handling Government balances had been found except in the time of the First and Second Banks of the United States. The Treasury had shown itself unequal to the task of a general regulation of the credit structure. A profusion of proposed remedies made a long period of investigation and controversy necessary before action could finally be taken. But practically all the various schemes of banking reform that were actively canvassed from 1907 to 1913 provided for some form of central banking organisation that could exercise "fiscal agency powers" and also be responsible for credit control. All this discussion culminated in the passing of the Federal Reserve Act in 1913. The establishment of the Federal Reserve System in 1914 opened a new chapter in the chequered history of the relations between the Government and the banks in the United States.

CHAPTER V

THE UNITED STATES, (*b*) THE FEDERAL RESERVE SYSTEM

THE Federal Reserve System was set up by the Democratic Congress and Administration that came into power in 1913 with President Woodrow Wilson. The historic dislike of the Democrats for an independent Central Bank and their dread of a " Money Trust " were therefore influential. Twelve regional bankers' banks were set up with a Federal Reserve Board, which was definitely a Government commission, to control them from the centre. The Secretary of the Treasury and the Comptroller of the Currency became ex-officio members of the Board, and the former was to preside at its meetings. The other five members (six from 1922) were appointed for ten-year terms by the President subject to confirmation by the Senate. We shall discuss in turn the relations that developed between this new system and the Government in regard to Government balances, Government borrowing, and general credit policy.

The framers of the Federal Reserve Act in its earliest form desired that all Government balances should be transferred to the Federal Reserve Banks within a year. Most publicists and economists who took part in the discussions of 1913 supported this proposal.[1] The Act, as passed by the House of Representatives, contained this provision. It was generally agreed that the existing Treasury system was " a great mistake," and that the Federal Reserve Banks would be " in better position to handle the affairs of the Government than any private

[1] Willis, " Federal Reserve System," pp. 123, 443, 447, 449.

banks."[1] Opposition came, however, from two groups. The first was the Treasury under Secretary McAdoo, possibly influenced by a reluctance to forego the political patronage and powers involved in the old sub-treasury and "pet bank" system. The second was the radical or Bryan wing of the Democratic party, which still disliked the idea of letting banks have the control and use of Government money.[2]

These influences triumphed in the Senate. An amendment was passed giving the Secretary of the Treasury the option of depositing Government funds (except certain trust funds) in the Federal Reserve Banks and of using them as fiscal agents. This amendment was accepted by the House in the belief that it would not really make any difference. Representative Glass said: "It is scarcely thinkable that we shall ever have a Secretary of the Treasury who would not so exercise the discretion conferred upon him by the Bill, as now reported, as to carry out the real purpose which the House had in view when it made this provision mandatory."[3] The Senate also struck out the provisions requiring equitable geographical distribution of Government funds among the various Federal Reserve Banks and payment of interest by them on Government deposits.[4]

The first deposits of public funds in the Reserve Banks were made in September 1915, when $15 millions was deposited in three of them. This took the place of the "crop-moving deposits" in National Banks that had become usual, but it seems to have been done for political reasons without any real need. In the next year the

[1] Willis, "Federal Reserve System," p. 382.

[2] *Ibid.*, pp. 247, 260, 1111–12. At one point Secretary McAdoo proposed "a plan of his own under the terms of which the Treasury would have gone, more or less extensively, into a banking business, with the various sub-treasuries as branches." This reversion to the ideas of Secretary Shaw was rejected by President Woodrow Wilson. See H. P. Willis, "The Federal Reserve Act in Congress," in *Annals of the American Academy of the Political and Social Sciences*, Jan. 1922, p. 40.

[3] Willis, "The Federal Reserve System," p. 513.

[4] Chapman, p. 44.

Secretary of the Treasury admitted that "crop-moving deposits" were no longer needed on account of the credit facilities provided by the Federal Reserve System.[1]

Government deposits were the subject of considerable discussion and even controversy behind the scenes for some time after the Federal Reserve System began work on November 16th, 1914. For over a year the Secretary of the Treasury took no action to transfer Government funds to the Reserve Banks except for the unwanted crop-moving deposits. Evidently the relations between the Secretary of the Treasury and the Federal Reserve Board were not over-cordial, and the Treasury Department was not in any hurry to give up any part of its powers and influence. It was only after some pressure from Congress that Secretary McAdoo announced in November 1915 the appointment of the Federal Reserve Banks as depositaries and fiscal agents from January 1st, 1916.[2] This did not affect the National Bank depositaries outside Federal Reserve cities. The Government's accounts in the twelve Federal Reserve cities with balances of about $9 millions belonging to the Treasury's General Fund were transferred from the National Bank depositaries to the respective Federal Reserve Banks.[3]

"Arrangements were made to have the collectors of customs and collectors of internal revenues in the twelve federal reserve bank cities deposit all of their funds in the federal reserve banks." The fiscal agency work became "an important and very active part of the work of the reserve banks almost immediately after the arrangement was established." These banks received "the principal revenues of the Government outside of postal funds," and paid "a very large proportion of government cheques and warrants." [4] However, it is said that even in Federal

[1] Finance Reports, 1915, pp. 4–11, and 1916, p. 7. Willis, *op. cit.*, p. 794.

[2] Willis, *op. cit.*, pp. 834–6, 873, 881–2, 1111–14, 1120–36.

[3] Annual Report of Federal Reserve Board, 1915, p. 6.

[4] Governor Benjamin Strong of the Federal Reserve Bank of New York, quoted by Kemmerer, "A.B.C. of the Federal Reserve System," pp. 103–4.

Reserve cities "in some cases Federal court funds and postmasters' funds remained where they had been previously kept."[1]

Professor Chapman has stated that the figures for Government deposits with the Federal Reserve Banks from January 1916 to March 1917 indicate "a policy of gradual transference of Government funds to them" by the Secretary of the Treasury.[2] This seems very doubtful. The balances depended chiefly on the Government's receipts and disbursements in Federal Reserve cities. The Secretary of the Treasury was unwilling at this time to extend the fiscal functions of the Federal Reserve Banks.[3] The Government balances in these banks in February and March 1917 were at a far lower level than in the corresponding period of 1916, but that is perhaps due to the fact that Government balances as a whole were low in the early part of 1917.

Nobody seems to have thought out clearly in advance what the requirements would be for convenient transaction of Government business throughout the country after the establishment of the Federal Reserve System. The Act, as originally framed, would have done away with all the National Bank depositaries and thrown all the work on to the Federal Reserve Banks. Great inconvenience would surely have been caused if there were no Government depositary banks except in the Federal Reserve cities. It was really quite essential to have agents of some kind to conduct the Government's financial transactions at other places.

A Government official who studied this question in 1915 stated that the Federal Reserve Banks obviously could not do the Government's work by themselves, and would have to make use of their member banks to receive Government deposits and pay Government

[1] M. S. Wildman, *Annals of the American Academy of the Political and Social Sciences*, January 1922, p. 132.

[2] Chapman, p. 54. The weekly figures are in the Annual Reports of the Federal Reserve Board, 1916, pp. 64–5, and 1917, pp. 66–7.

[3] Willis, *op. cit.*, p. 1115.

cheques.[1] This would practically make the whole body of member banks into Government depositaries, and was certainly nowhere contemplated in the Federal Reserve Act. Governor B. Strong recognised the difficulty there would be in trying to extend the fiscal functions of the Reserve Banks beyond their own cities.[2] In view of this, perhaps Professor Willis goes a little too far in referring to the whole body of National Bank depositaries as "pet banks" with "inactive deposits," and seeming to imply that they might all have been swept away.[3]

On June 30th, 1915, there were 1473 National Bank depositaries, of which 849 were "regular depositaries" conducting Government transactions, and only 624 were "temporary depositaries" with inactive accounts.[4] The temporary depositaries should certainly have been abolished, but this reform was delayed till 1920. To abolish the regular depositaries without putting something similar in their place would decidedly have been a mistake. In fact, it has been found desirable to retain them. They still exist to-day with some modifications, but the amount of Government business handled by them is relatively very small compared with that done by the Federal Reserve Banks.

Though the fiscal functions of the Reserve Banks were not very extensive from January 1916 to March 1917, the change involved in the relations between the Government and the banking system was really fundamental. Professor Wildman points out that the Treasury's bank accounts hitherto had been those rather of a savings depositor than a commercial depositor. They were operated on as a rule by cash receipts and payments rather than by credit instruments, and so could hardly be classed as "true active checking accounts." The new accounts with the Reserve Banks were on a different basis. The Reserve Banks did not have to furnish collateral security or pay interest on the balances,

[1] Willis, *op. cit.*, pp. 1130–33.
[2] Kemmerer, p. 103.
[3] Willis, *op. cit.*, pp. 1113–14.
[4] Finance Report, 1915, p. 193.

as the National Banks did. They had only to keep the same thirty-five per cent. cash reserve against them as against their other deposits. The Treasury made payments by cheques on these accounts which would frequently involve no cash payment, but only a book transfer from the Government account to the reserve account of a member bank; similarly cheques on member banks would be credited to the Government by transfer. Thus Government transactions could now be carried on with a much smaller cash basis than before. For the first time since 1846, the Treasury became a true bank depositor in the ordinary sense, and before long it became also a bank borrower.[1] It was indeed fortunate that this new relationship between Government business and the banking system became established before the entry of the United States into the World War, and provided a strong foundation for the resulting huge financial operations. The old clumsy system would have been a terrible handicap, and would undoubtedly have collapsed under the strain.

On April 6th, 1917, Congress declared that a state of war existed between the United States and Germany. The position of the Federal Reserve Banks as fiscal agents at once became vastly more important. The Treasury soon took up a new attitude, and was ready to use them in any way that seemed helpful.[2] Since the national expenditure rose from $682 millions in 1913 to $15,365 millions in 1919, it is clear that all possible help was needed.[3]

The figures for the distribution of the balances in the Treasury's General Fund [4] at the close of the fiscal year

[1] Wildman, *loc. cit.*, p. 132.

[2] Willis, *op. cit.*, pp. 1118–19.

[3] Wildman, *loc. cit.*, p. 133.

[4] The nature of the General Fund is explained in Finance Report, 1933, pp. 276–7. All Government receipts pass into it and all payments are made from it, though they are classified according to "General fund accounts," "Special funds accounts," and "Trust fund accounts." The balances shown are the free balances; the Treasury holds also large assets in gold and silver which cover specific liabilities.

in 1916 and 1917 are interesting. They are given below to the nearest million dollars in each case:

	June 30th, 1916.	June 30th, 1917.
In Treasury Offices (including the sub-treasuries, mints and assay offices) .	131	108
In Federal Reserve Banks	113	301
In regular (including temporary) National Bank depositaries	63	50
In special bank depositaries . . .	0	784
In Philippine Treasury	4	2
	311	1244

Balances in Federal Reserve Banks increased greatly, though not in proportion to the increase in the total balances, whilst those in Treasury Offices and the old National Bank depositaries actually fell off to some extent. But the most striking feature in this list is the emergence of a completely new class of depositaries called "special bank depositaries." This was due to an attempt to prevent the huge Government receipts from loans and war taxes from dislocating the money market. The policy already followed in the Civil War and the Spanish War of leaving the proceeds of loans in the banks till they were needed for disbursement was systematised and applied on a vast scale. The handling of Government deposits in the banking system thus became intimately bound up with Government borrowing, and both can now be considered together.

The first borrowing by the Government in preparation for the War was in the form of ninety-day certificates of indebtedness for $50 millions at two per cent. sold to the Federal Reserve Banks on March 31st, 1917. The Reserve Banks paid "in the form of credit in their books" and "the money market effect was a simple inflation of reserve funds."[1] The dangers of this procedure were

[1] "The New York Money Market," ed. B. H. Beckhart, Vol. IV, p. 269. Cf. Finance Report, 1917, pp. 14–15, and Willis, *op. cit.*, pp. 1115–16. Prof. Willis states that the rate of interest was later raised to two and a

quite obvious, and it was not repeated. Inflation of reserve funds on a vast scale through Federal Reserve open-market operations was to be adopted later as a deliberate anti-depression policy in 1932–33, but that is a different story. One man's poison is another man's medicine!

The First Liberty Loan Act, passed on April 24th, 1917, authorised the sale of certificates of indebtedness in anticipation of the proceeds of the Liberty bonds. Under Section 7 the Secretary of the Treasury could designate any incorporated banks and trust companies as special depositaries, and deposit with them the proceeds of the bonds or the certificates. Thus every incorporated bank was eligible to become a special depositary, whether working under a National or a State charter and whether or not it was a member of the Federal Reserve System. The banks were to furnish collateral security in advance, and pay interest on the deposits, but no cash reserves need be kept against them; these arrangements were the same as those applying to the regular National Bank depositaries.[1] The Second Liberty Loan Act of September 24th, 1917, repeated these provisions with some modifications.

> "Up to the present day, deposits of the proceeds of certificates of indebtedness and other refunding issues are made under authority of the Second Liberty Loan Act as amended." [2]

Treasury circulars 79, 81 and 92 gave the detailed rules for working the special depositary system.[3] The provision in the Liberty Loan Act for depositing in banks the proceeds of borrowing was interpreted as permitting payment by credit on the books of the special depositary banks.

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half per cent. as the Reserve Banks thought two per cent. too low, and that the certificates were in fact held for six months. These facts do not appear in the Finance Report.

[1] Finance Report, 1917, p. 85.

[2] Beckhart, "The New York Money Market," Vol. IV, p. 270.

[3] Finance Report, 1917, pp. 124–36.

In the first five months of America's participation in the War, the commercial banks paid for certificates of indebtedness in current funds. Up to May 25th, 1917, the proceeds were kept as Government deposits with the Reserve Banks. From that date the practice was to redeposit them with the subscribing banks, if they had qualified as special depositaries. From August 28th, 1917, by "administrative tolerance of the Treasury," the system of payment by bank credit was extended to certificates of indebtedness.[1] The banks could pay for them either in credit or in cash. Sample figures given by Professor Hollander for the Federal Reserve District of Boston show payment by credit covering about eighty-five per cent. of the total.[2] Cash payment, however, was not really very different from payment by credit, since the cash proceeds were normally redeposited at once.

Instalments on war-loan subscriptions were from the first payable by banks for themselves and on behalf of their customers in three ways, at the option of the paying bank, namely, (1) cash, (2) credit, and (3) surrender of certificates of indebtedness. Payment by credit seems to have been used to the extent of about fifty per cent. of the total as a rule. Here again, unexpended cash proceeds were redeposited with subscribing banks that had qualified as special depositaries.

In 1918 the special depositary system was extended for a time to cover also the receipts from the income and excess profits taxes.[3] Payment by credit was not allowed. The taxes were to be paid either in cash or by surrender of certificates of indebtedness, but the unexpended cash proceeds were redeposited at once in the banks if they had qualified to receive them. What actually happened has been described as follows:

"The collectors of internal revenue in the district deposited their receipts . . . with the federal reserve bank, and then the federal reserve bank took all the cheques which were drawn on

[1] J. H. Hollander, "War Borrowing," pp. 37, 78.
[2] *Ibid.*, pp. 64–5. [3] Finance Report, 1918, pp. 79–80 and 308–19.

any of the depositary banks in the district, sorted them out and deposited them right back in the depositary bank from which they came. When it received from the collector of internal revenue a bunch of cheques, coming, say, from Rochester, it sorted out those cheques and sent them back for deposit in the proper banks in Rochester." [1]

The Federal Reserve Banks were the indispensable agents through which the whole special depositary system was worked. This was only one part of their splendid services in carrying out almost all the routine work connected with the heavy war borrowing, and also organising the widespread propaganda for investment in Liberty Bonds. The Reserve Banks set up Committees to value the collateral tendered by special depositaries, kept the accounts, and issued calls on the banks for payment of stated amounts out of their Government deposits when required by the Secretary of the Treasury. The deposits were always payable on demand, but usually about five days' notice was given of every call.[2] The practice of the Treasury has always been to call for a fixed percentage of the deposits of all special depositary banks throughout the country at the same time in regard to each issue of Government securities in chronological order, thus avoiding any suspicion of favouritism. Any disproportion between the funds thus made available and the funds needed for disbursements at the various Reserve Banks could always be adjusted by inter-district transfers. The machinery of the gold settlement fund at Washington proved itself most useful in facilitating these transfers, which war financing made necessary on a large scale.[3]

The funds withdrawn from the special depositaries would, of course, be disbursed and find their way back to the banks, but only after an interval. Moreover, they would come back as ordinary deposits of private customers, and the banks would have to keep the usual reserves against them. The help of the Reserve Banks was needed to prevent strain, when the Government

[1] Kemmerer, p. 110. [2] Hollander, p. 143.
[3] Willis, "Federal Reserve System," p. 1120.

deposits were withdrawn from the special depositaries, by giving adequate rediscounting facilities. They showed themselves very ready to co-operate at all times. Preferential discount rates were established for notes of member banks covered by Government obligations. The Federal Reserve Banks

> "were further authorised to discount for non-member banks, upon the endorsement of a member bank, notes secured by government obligations, whether made by the non-member banks themselves or by their customers, when the proceeds had been or were to be used for carrying certificates or bonds." [1]

Professor Willis states that the establishment of these preferential rates was due to "pressure from the Treasury Department." [2]

If the Government deposits were obtained from previously existing deposits and the ordinary lending power of the commercial banks, the demand for extra reserve funds for passing the deposits through the Reserve Banks need only be temporary. Government spending would return the deposits to the commercial banks, and thus restore the previous normal level of total deposits and of reserve funds after repayment of what was borrowed from the Reserve Banks. Moreover, if an evenly balanced flow of these deposits into and out of the Reserve Banks were established, with the Government balance in the Reserve Banks at a constant level, there would be no further need for more extra reserve funds even temporarily in the market as a whole. But so far as the Government deposits were purely inflationary, the commercial banks would require extra reserve funds to cover them in full when transferring them to the Reserve Banks, and would still need on the average about ten per cent. of these extra reserve funds to hold against the deposits when they came back as private deposits after disbursement by the Government. So long as more Government deposits were being created by credit

[1] Hollander, p. 144.

[2] H. P. Willis and others, "The Banking Outlook," p. 676.

inflation, the need for more reserve funds would thus be cumulative, and this is clearly what happened during the war period.

The Treasury hoped, by means of a policy of continuous borrowing through certificates of indebtedness, to draw funds gradually from the money market, and return them through disbursements at an equal rate, so as to avoid any accumulation of heavy balances. This proved to be impossible. From the time of America's entry into the War, the balance in the General Fund showed a steep upward trend till 1919, whilst fluctuating rapidly all the time. The effect of the special depositary system was to ensure that the very rapid fluctuations took place chiefly in the balances held by the special depositary banks, whilst the balances held by other depositaries were much steadier. The graph of Government deposits in special depositary banks shows a peak after each new certificate or bond issue; the highest point is at about \$2·4 thousand millions late in 1917, and it went over \$1·5 thousand millions twice in 1918. During the same period covering the War and the early post-war years, Government deposits in the Federal Reserve Banks rose to a high point of nearly \$500 millions at the end of 1918, and those in Treasury offices went over \$500 millions towards the end of 1919.[1]

According to Professor Hollander, the "essential service" of the special depositaries was the creation of credit, so as to provide the Government with purchasing power through additional bank deposits. He calls this "fiat credit," on the ground that it was "not a deduction from an existing limited stock, but the provision of a new additional supply with no limitation short of the remote check of an ultimate gold reserve."[2] Other authorities have emphasised the service of the special depositary system in preventing the Government's operations from hampering business or disturbing the

[1] These movements are shown in graphs in Beckhart, "The New York Money Market," Vol. IV, pp. 263, 272–3.

[2] Hollander, p. 142.

money market. Thus Professor Chapman states that the aim was "to keep the balances well scattered so that all sections of the country could use these funds until called in by the federal reserve banks . . . for the Treasury," and that "the government balance was thus kept in the banks which were supporting business."[1] Another view is that the important service of the special depositaries lay in preventing the extreme fluctuations of Government balances "from taking place in reserve funds, as would have been the case under the original plan of the Federal Reserve Act."[2] These views are at first sight difficult to reconcile. The important cause of difference seems to be that Professor Hollander is thinking of Government deposits created purely by inflation, whereas the other views quoted apply rather to the transfer of existing bank deposits to the Government without any inflation.

The special depositary system was at first mainly intended to facilitate the transfer of existing deposits. At that stage it minimised the disturbance to ordinary business and to the lending power of the commercial banks, by limiting the strain on their reserve funds for transfer of Government deposits, and by keeping Government balances in the Reserve Banks steady. When Government needs soon came to be met by inflation of total bank deposits and corresponding inflation of reserve funds, there was no fear that business would be hampered, and the steadying of Government balances in the Reserve Banks ceased to be important. There can be little doubt that the bulk of the funds lent to the Government was provided by credit inflation. To use them in business until they were required by the Treasury would therefore produce an active inflationary effect sooner than need be. But in fact it is clear that inflationary deposits, which were created solely to pay for the Government securities pledged as collateral against them, could not be lent to third parties by the banks and had no effective

[1] Chapman, pp. 178, 189–90.
[2] Beckhart, "The New York Money Market," Vol. IV, pp. 381–3.

existence till they were drawn out by the Government. Transfer to the Federal Reserve Banks had to take place sooner or later, and was facilitated by discounting notes backed by the Government obligations. It does not appear that the mere postponement of the transfer was at all important. Transfers of reserve funds obviously could cause little disturbance when they were available for this purpose to an indefinite extent on a basis involving no net cost. The whole process hardly affected the ordinary operations of the commercial banks until the deposits came into private hands after being withdrawn and disbursed by the Treasury. Thus for the war-time period of active credit inflation we conclude that Professor Hollander's view as to the chief service of the special depositary system is clearly correct. The special depositary banks gained the difference between the interest on the Government obligations held against the Government deposits (ranging from about three to six per cent.) and the two per cent. which they paid on them to the Government. This seems rather a high rate of payment for their service in standing ready to create "fiat credit." [1]

It is generally held that the Federal Government deserves great credit for not borrowing directly from the Reserve Banks during the War after the first issue of certificates, except for temporary overdrafts. Thus Dr. Burgess says: "The Treasury to its everlasting credit did not borrow directly from the Reserve Banks." [2] Special short-term certificates of indebtedness, however, were frequently issued to the Reserve Banks for a few days when necessary to cover a temporary shortage of Treasury funds. From April 6th, 1917, to October 31st,

[1] Governor Benjamin Strong of the New York Federal Reserve Bank stated that there was a great saving to the Government from the fact that the commercial banks did not charge a commission for receiving subscriptions to Government securities. Perhaps this would about even things up. See "Stabilization" Hearings before the House Committee on Banking and Currency on H.R. 7895, 1927, Part I, p. 451.

[2] W. R. Burgess, "The Reserve Banks and the Money Market," p. 104.

1919, the total amount of these special certificates issued was \$7·6 thousand millions, of which the New York Reserve Bank took \$5·5 thousand millions. In the next two years this method of financing was used still more, and a further \$11·1 thousand millions of special certificates was issued, of which the New York Reserve Bank took \$6·2 thousand millions.[1] Apart from these special short-term issues, the Reserve Banks were not expected to subscribe themselves for Government obligations, but only to get them distributed among the member banks and the public, which they did most efficiently. Of course it was open to the Reserve Banks to buy Government securities if they thought fit, but their purchases at this time were on a very modest scale. At the end of 1918 they held \$239 millions in U.S. Government securities, and their average holding over the whole year was \$128 millions.[2]

A different story appears, when we come to look at the amount of paper secured by Government war obligations which was discounted by the Reserve Banks. This total was rising throughout the year 1918; it started at \$286 millions and was as high as \$1,400 millions by the end of the year.[3] In this way Reserve Bank credit was used to support Government war borrowing practically as much as if the Government had borrowed directly. The final result was not very different from what happened in England, though the procedure in bringing about credit

[1] Finance Report, 1919, p. 264, and 1921, p. 173. According to H. G. Hendricks, "The Federal Debt, 1919–1930," p. 26, these special certificates were issued at the market rate of interest. But the Annual Report of the Federal Reserve Board, 1920, p. 91, shows that in the earlier part of 1920 the Reserve Banks carried large amounts of these certificates at two per cent., far below the market rate.

[2] Annual Report of the Federal Reserve Board, 1918, pp. 131, 192.

[3] *Ibid.*, pp. 9–10. See also the tables in Annual Report of the Federal Reserve Board, 1926, pp. 40–42, from which it can be seen that the proportion of "bills discounted secured by U.S. Govt. obligations" to "total bills and securities" for all Federal Reserve Banks rose from about fifty per cent. in the middle of 1918 to about seventy-five per cent. in the middle of 1919, and then declined till it stood at about twenty-five per cent. from the beginning of 1922.

inflation was different. In England the Central Bank expanded its credit by making advances to the Government and others; on this base the commercial banks expanded credit in turn, and their excess funds were in one way or another borrowed for the use of the Government. In the U.S.A. credit was written up in the first place by the commercial banks for the use of the Government, and the necessary expansion of Reserve Bank credit was then effected by discounting notes secured by Government paper. Evidently each country adopted, more or less unconsciously, the method that fitted in with its own institutions and circumstances.

The special depositary system did not disappear after the War, as might have been expected. The Treasury regarded it as a very useful invention, and it has become an established part of the fiscal arrangements of the United States. Thus the Finance Report of 1920 speaks of "the Treasury's valuable special depositary system," whilst that of 1931 states that "the special depositary system continued to function with its customary efficiency."[1] The technique of the system, as it worked after the War, was officially described as follows:

> "Working funds to carry the Government through the next quarter are secured in large part through the issue of new certificates of indebtedness, falling due on a future tax payment date not more than a year off. Payment for these certificates does not itself withdraw the funds from the market, because the practice is to sell the certificates to banks throughout the country and to permit the banks to make payment by creating deposit credits in favour of the Government, duly secured, on which the banks pay moderate interest. These deposits are drawn on from time to time, but only as the Government actually needs the funds for amounts to be very shortly paid out and, hence, returned to the market."[2]

The essential point about the special depositary system, as described in this extract, seems to be that the

[1] Finance Report, 1920, p. 174, and 1931, p. 134.

[2] *Ibid.*, 1921, p. 389, from an address by Assistant Secretary of the Treasury Ballantine.

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[2] Annual Report of the Federal Reserve Board, 1918, pp. 131, 192.

[3] *Ibid.*, pp. 9–10. See also the tables in Annual Report of the Federal Reserve Board, 1926, pp. 40–42, from which it can be seen that the proportion of "bills discounted secured by U.S. Govt. obligations" to "total bills and securities" for all Federal Reserve Banks rose from about fifty per cent. in the middle of 1918 to about seventy-five per cent. in the middle of 1919, and then declined till it stood at about twenty-five per cent. from the beginning of 1922.

inflation was different. In England the Central Bank expanded its credit by making advances to the Government and others; on this base the commercial banks expanded credit in turn, and their excess funds were in one way or another borrowed for the use of the Government. In the U.S.A. credit was written up in the first place by the commercial banks for the use of the Government, and the necessary expansion of Reserve Bank credit was then effected by discounting notes secured by Government paper. Evidently each country adopted, more or less unconsciously, the method that fitted in with its own institutions and circumstances.

The special depositary system did not disappear after the War, as might have been expected. The Treasury regarded it as a very useful invention, and it has become an established part of the fiscal arrangements of the United States. Thus the Finance Report of 1920 speaks of "the Treasury's valuable special depositary system," whilst that of 1931 states that "the special depositary system continued to function with its customary efficiency."[1] The technique of the system, as it worked after the War, was officially described as follows:

> "Working funds to carry the Government through the next quarter are secured in large part through the issue of new certificates of indebtedness, falling due on a future tax payment date not more than a year off. Payment for these certificates does not itself withdraw the funds from the market, because the practice is to sell the certificates to banks throughout the country and to permit the banks to make payment by creating deposit credits in favour of the Government, duly secured, on which the banks pay moderate interest. These deposits are drawn on from time to time, but only as the Government actually needs the funds for amounts to be very shortly paid out and, hence, returned to the market."[2]

The essential point about the special depositary system, as described in this extract, seems to be that the

[1] Finance Report, 1920, p. 174, and 1931, p. 134.

[2] *Ibid.*, 1921, p. 389, from an address by Assistant Secretary of the Treasury Ballantine.

banks' subscriptions to Government obligations remain purely nominal until the resulting deposits are called, and meanwhile do not affect reserves or reduce ordinary lending power. This sounds very inflationary. But in effect (see p. 179 below), the Government's regular quarterly deposits with the special depositaries really came mainly from the quarterly payments of income tax. Thus on the whole it was existing bank deposits that were gradually transferred to the Reserve Banks and returned to the commercial banks through Government spending during each quarter. Under normal peace-time conditions the banks would not rely altogether on special discounts with Reserve Banks when called on to transfer the Government deposits, but would tend, if necessary, to curtail their other activities in order to adjust their reserve position. It is then correct, under these circumstances, to say that the special depositary system enables the Government to postpone its withdrawal of funds from the market and to confine the reduction of the banks' reserve funds to as short a period as possible. Thus the service of limiting disturbances to business and to the reserve funds of the banking system from Government operations seems to be of much greater importance in the ordinary post-war working of the special depositary system than during the War period, when the Government's needs were really being met mainly by credit inflation.

In the period 1921–30 the total Treasury balances in the General Fund gradually fell from about \$800 millions to about \$300 millions on the average for a year. At the same time there were wide fluctuations in the course of each year, with a range of some \$300 millions to \$600 millions. Deposits in Treasury Offices in the same period fell from \$400 millions to \$100 millions, with only very minor fluctuations. The Government deposits in the Federal Reserve Banks meanwhile moved between about \$10 millions and \$120 millions, but from 1926 they seldom rose above \$50 millions. The deposits in special depositary banks, however, showed very great

fluctuations, *e.g.* they varied between practically zero and over \$400 millions in each of the years 1927, 1928 and 1929.[1] Evidently the great bulk of the fluctuations occurred in the balances held by special depositaries.

Government short-term borrowing on certificates of indebtedness was no doubt facilitated by the special depositary system in the decade 1921–30, and prevented from disturbing the money market as much as it might have done. Whether it was really necessary or desirable for the Government to go on borrowing on a large scale at this time is a different question. Since the Federal debt was reduced from about \$27 thousand millions to under \$17 thousand millions between 1919 and 1930, it appears strange at first sight that the Government should still be a large short-term borrower during this period. The borrowing was, of course, largely due to maturities and changes in the form of the debt. Up to 1926 the volume of certificates of indebtedness was greatly reduced, and the Treasury relied more on notes of three to five years' duration for refinancing. From 1926 to 1929 certificates increased rapidly again in volume.

Probably the chief reason for keeping a large amount of debt in short-term form was the desire to have it readily available for redemption from the regular surpluses of these years.[2] Professor Willis considers that this whole policy was a great mistake, and had very bad effects on the Federal Reserve System. In 1929 he wrote:

"At the rates which Treasury certificates have borne, they could never have been maintained at par or near it had not the reserve banks been pressed into service and directed to render their aid. They have been relied upon, not only to discount pretty much anything that came along, provided it were accompanied by Treasury certificates as collateral, but they have also

[1] These movements are shown in graphs in Beckhart, "The New York Money Market," Vol. IV, pp. 381–3.

[2] Hendricks, pp. 72, 85, 278. See also Finance Report, 1929, p. 39, where the Secretary of the Treasury states as a further advantage that interest costs were reduced by keeping part of the debt in short-term form.

been expected by repurchase agreements to bring about the desired result—that of taking an excess of certificates off the market when necessary. . . . In this way holders of Treasury certificates could always rely on getting cash for stock market purposes." [1]

Another writer suggests very plausibly that the banks buying the certificates had to keep funds easily realisable in order to meet the calls. For this reason he thinks that the increase in the certificate debt between 1926 and 1929 caused a pressure of short-term funds in the call loan market, which was "sufficient to produce disturbances of major proportions in the market." [2] Evidently the special depositary system has not been perfect as a method of preventing money market disturbances.

The calls for payment of the Government balances held by special depositaries are made by the Federal Reserve Banks at the direction of the Treasury in the form of a demand for an equal percentage of the proceeds of a given issue from all the banks concerned. A few days' notice is given as a rule. The Treasury alone has power to order transfers of Government deposits under the following rule:

"The public moneys in the hands of any depositary may be transferred to the Treasury of the United States or may be transferred from one depositary to any other depositary as the safety of the public moneys and the convenience of the public service may require." [3]

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[1] *Journal of Commerce*, March 8th, 1929, p. 4.

[2] Hendricks, pp. 289–90.

[3] Finance Report, 1931, p. 618. The statement of Kisch and Elkin (*op. cit.*, p. 37), that during the War the Federal Reserve Banks distributed Government funds among the other banks according to their local knowledge, is no doubt due to a misunderstanding of the special depositary system. The following is a sample notice of a Treasury call taken from the *New York Herald Tribune*, May 1st, 1934: "Notice was sent yesterday to depositary institutions in the 2nd Federal Reserve District that the Treasury has called $18,172,500 for repayment on May 3rd, representing six per cent. of the amounts on deposit for the account of the two and a half per cent. notes and the one and a half per cent. certificates, both dated January 29th, 1934. The call for the entire country totals $34,176,300. After this withdrawal there will remain on deposit $750,521,663 in the 2nd [*i.e.* New York] District and $1,314,133,600 in the country."

It is possible that a Federal Reserve Bank might, in anticipation of the sanction of the Treasury, withdraw a Government deposit from a bank that it thought likely to fail, but this would be a very exceptional procedure.

The movement of public funds for political reasons seems now to be quite a thing of the past. By making percentage calls on all special depositaries the Treasury guards itself completely against any such charge. The Treasury still exercises some discretion as to the distribution of its funds between the special depositaries and the Reserve Banks. The general aim is to keep the balances in the Reserve Banks steady and let the balances with special depositaries fluctuate. But in special circumstances this policy may sometimes be modified. There is reason to believe that both in 1919 and 1928 and probably also in 1929 the Treasury co-operated with the Federal Reserve Board in the attempt to check speculation by withdrawing the proceeds of certificate sales from the banks more rapidly than usual.[1] As regards the distribution of Government deposits between different parts of the country, Professor Willis has compiled some interesting figures. They show a tendency to concentration in the Eastern States on the Atlantic sea-board, *i.e.* primarily in New York City, both in 1921 and again from 1931. But the distribution is found to be reasonably proportionate to that of total banking resources. This, indeed, is what one would expect, since the bulk of the deposits, those in special depositaries, are distributed according to the banks' subscriptions at their own option to Government issues. In 1932 U.S. Government deposits formed 2·44 per cent. of total demand deposits for all banks.[2]

The number of special depositary banks declined by about sixty per cent. in 1928 owing to the elimination of the inactive ones by the Treasury. But the number of qualified banks rose sharply in 1932, and the total deposits held by them have been much larger again from 1931

[1] Hendricks, pp. 290, 293.

[2] H. P. Willis, " The Banking Outlook," pp. 468–72.

" due to the larger financing operations required " during the depression.[1] There has been great eagerness to subscribe for the Government's short-term obligations owing to the desire for liquidity and general reluctance to invest for longer terms that have prevailed since 1932. Since excess reserves of member banks have been built up to over $1·5 thousand millions in the early part of 1934, it is clear that the commercial banks would have no difficulty in transferring their Government balances to the Reserve Banks. However, the maintenance of balances with special depositaries tends to keep up the pressure of excess reserves in pursuance of the Government's policy of credit expansion. At times the Treasury seems to have deliberately put off calling in and spending its balances from subscribing banks, in order to avoid causing an outflow of funds from New York and consequent fall in excess reserves at the point where they are considered most effective in leading to increased loans and investments.[2]

In 1929 the Secretary of the Treasury discussed the special depositary system, and thought that though "excellent so far as it goes," it had some definite disadvantages.

> " Until (he says) the Government has actual use for the funds borrowed, it loses the difference between the coupon rate of the securities issued and the two per cent. which it receives from the banks on its deposits."

And again,

> " The banks subscribe for Treasury certificates mainly because of the deposit privilege. A bank can generally afford to subscribe for these certificates and sell them immediately after or even previous to their issue at a discount, to the detriment of the Government credit." [3]

In selling certificates to a customer the bank obtained

[1] Finance Report, 1928, pp. 111–12, and 1932, p. 121. See Table III on p. 200 for the numbers of depositaries.
[2] *New York Herald Tribune*, March 13th, 1934.
[3] Finance Report, 1929, p. 40.

funds which it could use until they were called by the Treasury, and it could afford to give the customer the benefit of part of the profit arising from such use.

Dr. Hendricks has pointed out that in fixing the interest to be paid by the depositaries a " one-way rule " was followed by the Treasury. The rate stood at two per cent. from June 1st, 1913, to December 1st, 1930, and was not put up when the banks were making handsome profits from the higher rates paid on Government issues during and just after the War. But when short-term market rates fell during the depression, the Government could not delay reducing the interest required from depositaries. The banks obviously would not work the system at all unless they derived a certain minimum profit from it to repay them for the trouble. The rate was reduced by three steps till it reached one-half per cent. on June 1st, 1931.[1]

In June 1933 the Treasury amended its rules, so as to require only one-quarter per cent. interest from special depositaries as from June 15th, 1933, but on June 16th, 1933 the Banking Act of 1933 was passed. To conform with the spirit of Section 11(*b*) of this Act, intended to eliminate interest on demand deposits, the Treasury decided that as from June 15th, 1933, no interest should be paid on balances held by special depositaries.[2] Of course the elimination of one-quarter per cent. interest is not of much importance under present conditions. Short-term rates of interest, however, will presumably not always remain at such an extraordinarily low level. When they have risen, it seems very doubtful whether public opinion will permit the Government to continue an arrangement which will practically amount to a subsidy to the banks. The special depositary system could perhaps be modified so as to make it less one-sided in its benefits. Alternatively it might be abolished if the Government were to reduce its short-term financing to a

[1] Hendricks, p. 299, and Finance Report, 1931, p. 135.

[2] Finance Report, 1933, pp. 70, 267, and Treasury Circular of June 2nd, 1933, amending Department Circular, No. 92.

minimum, leaving the Federal Reserve authorities to take such action as might seem necessary to offset the temporary effects of payments for Government obligations in current funds. We shall return to the question of a possible reorganisation of the whole depositary system, after tracing the development of the other parts of it during and after the War.

In the War period the number of "regular" National Bank depositaries remained roughly stationary. Some additional ones were designated, and the balances with others were increased to provide for war disbursements.[1] In December 1919 the Treasury undertook a general revision of the arrangements, and laid down its new policy in Department Circular No. 176. All the inactive accounts, of which there had been 566 on June 30th, 1919, were closed. There was a certain amount of protest through political channels, but the need for economy was strong enough to make it possible to carry through this long overdue reform.[2] Thus the "pet banks," officially known as temporary (formerly special) National Bank depositaries, ceased to exist.

Another belated reform was achieved by the General Appropriation Act of May 29th, 1920. This provided for the abolition of the sub-treasuries, which had maintained their existence till then through political influence. They might conceivably have lasted much longer but for the course of events during the War, which made clear the greater convenience and economy of handling Government business through the Reserve Banks. It could not be maintained after the War that the sub-treasuries served any important public purpose. Under the Act of 1920, the transfer of their functions to the Treasurer, the Mints and Assay Offices and the Federal Reserve Banks was completed in 1921.[3] The disappearance of these remnants of the Independent Treasury system was only the logical result of the actual transference

[1] Finance Report, 1920, p. 172. See also Table III on p. 200.
[2] Finance Report, 1920, pp. 523–37, and Chapman, p. 120, note.
[3] Wildman, *loc. cit.*, p. 130. Willis, "The Banking Outlook," p. 667.

of Government business to the Reserve Banks during the War.

From 1920 the Treasury policy was to have " general " National Bank depositaries only where they were actually needed to receive cash payments for Government account and to pay out cash on Government warrants. Balances carried with such depositaries were to be fixed at the minimum " necessary for the transaction of essential Government business." It was ordered that officers collecting Government dues should, unless specially directed otherwise, send all cheques daily to the Federal Reserve Bank of the district. Only cash receipts might be paid in to the Government's account with a general depositary bank.[1]

In the course of this reorganisation a new class of " limited " National Bank depositaries came into existence and first appears in the accounts in 1920. Probably this was originally a reclassification under systematic rules of some of the existing depositaries which in practice were found to be doing only a limited kind of business. Henceforth these limited depositaries were qualified only to receive and make payments in connection with the official disbursing accounts of certain Federal officials, chiefly postmasters and officers of Federal courts. Such accounts could, of course, also be held by general depositaries in addition to the general Government account in the name of the Treasurer of the United States. Disbursing accounts of Federal officials, other than those specially excepted, are carried on the books of the Treasurer. This means that the Treasurer advances funds to the disbursing officers on warrants which technically constitute expenditure, though the amounts in fact remain in the Treasurer's balances, until paid out on cheques given by the disbursing officers to the Government's creditors.[2]

The number of limited depositaries rose rapidly, and there were 845 of them by June 30th, 1922. A further rise in 1930 was perhaps due to the addition of some State

[1] Finance Report, 1920, pp. 172–3.
[2] *Ibid.*, 1931, pp. 133–4, and 1933, p. 276.

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[1] Finance Report, 1920, pp. 172–3.
[2] *Ibid.*, 1931, pp. 133–4, and 1933, p. 276.

banks and trust companies to this class. An Act of Congress, dated May 7th, 1928, placed State banks and trust companies which have become members of the Federal Reserve System on the same footing as National Banks in regard to eligibility to act as fiscal agents and regular depositaries for the Federal Government.[1] It seems unlikely that many State banks have been appointed as general depositaries, as the total number of these has remained very stable. In 1932 and 1933 the regular depositaries were not classified as general or limited in the annual Finance Reports of the Secretary of the Treasury; they were all classed together as "member bank depositaries." The total number of these fell from 1345 on June 30th, 1931, to 1295 a year later. The decrease was no doubt due mainly to the large number of bank failures. Separate figures kindly furnished by the Secretary of the Treasury show that the decrease was almost entirely in the limited depositaries. (See Table III at the end of this chapter, p. 200.)

The Finance Report of 1931 stated that the general depositaries were receiving about $35 millions a month as Government deposits, "which are remitted daily to the respective Federal reserve banks." This evidently means that the excess of the Government balance over the balance fixed for each general depositary must be remitted, as laid down in Treasury Circular No. 176.[2] These fixed balances are revised every half-year according to the business done and any special circumstances that may exist.[3] Whenever the credit balance in the Treasurer's account with a general depositary falls below the fixed amount, he will at once restore it on request by "directing the appropriate Federal reserve bank or branch to credit

[1] Annual Report of the Federal Reserve Board, 1928, p. 36. Prof. Kemmerer (*op. cit.*, p. 107) wrongly states that this law refers to special depositaries. All State banks and trust companies were eligible to qualify as special depositaries from the beginning of the credit-payment system in 1917.

[2] Finance Report, 1931, p. 133. Willis and Steiner, "Federal Reserve Banking Practice," p. 670.

[3] Finance Report, 1925, p. 98.

the depositary bank's reserve account or to make payment to its correspondent." Such replacements generally amount to a little over $120 millions a year.[1] In the fiscal year 1931 these banks were furnishing " cash to Government disbursing officers and upon pay-roll cheques " to the amount of about $11 millions a month, and the average Government balances with them were about $7 millions.[2]

The deposits of disbursing officers in limited depositaries " are not, generally speaking, subject to control by the Treasury . . . (but) are subject to the control of the administrative officers." Accordingly, the Treasury does not prescribe any fixed balances for such accounts. But these Government deposits, like all others under the present rules, must be fully covered by collateral security. For general and limited depositaries this is held by the Treasury. If any limited depositary receives Government deposits to an amount exceeding the value of the collateral already deposited, calculated according to the rules, it must at once report the fact to the Treasury and deposit additional security.[3] The Government balances held by limited depositaries averaged nearly $20 millions in 1930 and 1931.

The balances held by the regular depositaries as a whole have been very stable, being roughly $60 millions in the years 1917–20, and from $25 millions to $28 millions since then.[4] Interest was paid on these balances from 1908 to 1933, and the rate was reduced to one-half per cent. in 1931 owing to the depression, as already described for special depositaries. The requirement of interest was finally abolished with effect from July 1st, 1933, as a result of the Banking Act of 1933.[5] The abolition of interest is not of much importance in regard

[1] Finance Reports, 1928, p. 591; 1930, p. 428; 1931, p. 596.

[2] Finance Report, 1931, p. 133.

[3] Finance Reports, 1925, p. 98, and 1930, pp. 426–7.

[4] This is shown by graphs in Beckhart, " The New York Money Market," Vol. IV, pp. 273, 383.

[5] Finance Report, 1933, pp. 70, 268.

to these depositaries, seeing that they render services in return for the balances they hold, and moreover the fixed balances of the general depositaries are adjusted from time to time according to circumstances.

It should be mentioned here that there is an entirely separate system of depositary banks for postal savings funds, which is worked on lines somewhat similar to those for limited depositaries.[1] The importance of the postal savings system has greatly increased during the depression owing to the widespread attitude of distrust towards the ordinary banks. On June 30th, 1932, there were 5,102 banks holding postal savings funds to a total amount of \$681·7 millions.[2] At that time the total deposits in the postal savings system were \$784·8 millions, but by the end of 1933 they had grown to \$1,209·4 millions.[3] Probably this rapid increase will not continue now that the bulk of all small accounts in the ordinary banks are guaranteed by the Government through insurance by the Federal Deposit Insurance Corporation.

In the fiscal year 1932 a total of 192 depositary banks (regular and special), with Government balances of about \$26·7 millions, closed for liquidation. This compares with eighty banks in 1931 and eighty-nine in 1933. The Government is, of course, protected against loss by the collateral security it holds. The Finance Report for 1932 states that "to date the United States has not sustained any losses through the failure of depositary banks," although in view of the depressed market for bonds "the Treasury has not, in so far as consistent with the protection of its interests, pressed the sale of securities held as collateral in cases where the immediate sale would cause a loss to the trust."[4] However, there is some

[1] Willis and Steiner, pp. 675–9.

[2] 72nd Congress, 2nd Session, House Document, No. 424, "Operations of the Postal Savings System, 1932," p. 2.

[3] 20 *Federal Reserve Bulletin* (March 1934), p. 194.

[4] Finance Reports, 1931, p. 134; 1932, p. 121; 1933, p. 70. In 1933 the Treasury adopted "temporary expedients" after the banking holiday to avoid withdrawing depositary privileges from ninety-three general depositaries and about 350 limited depositaries, which for the time being were only allowed to operate on a restricted basis.

feeling that it was not quite fair for the Government to take special security for its deposits and thus indirectly put itself in the position of a preferred creditor. The commercial bankers urge that public deposits in their banks should have the same status as private deposits, so that the same percentage reserve requirements would apply to them, but no special security would be taken. This amounts to asking to be allowed to hold Government deposits on the same terms as apply now to those held by the Federal Reserve Banks.[1] If the Federal Government thinks it essential that it should be a preferred creditor, it would be fairer to legislate for this directly and save all the trouble with collateral security. This is what has been done in Canada, where prior claims against the assets of a failed bank are given first to the holders of its notes, then to the Dominion Government to the extent of its deposits, and then to Provincial Governments to the extent of their deposits.[2]

The relative size of the balances held by the various parts of the Government's depositary system is indicated by Table II on p. 168, showing the distribution of the balance in the General Fund of the Treasury at the end of each of the last four fiscal years. In the last column the figures are also given from the latest Treasury Daily Statement available at the time of writing. These, of course, have been affected by the devaluation of the dollar to 59·06 per cent. of its former gold parity as from January 31st, 1934.

The amount "in Treasury Offices" is in the Treasury at Washington and the various Mints and Assay Offices, as there have been no sub-treasuries since 1921. It does not include silver dollars held against silver certificates or the gold held against certain specific obligations, viz. about fifty per cent. reserve against U.S. notes ("green-backs"), one hundred per cent. against gold certificates and the gold certificate fund of the Federal Reserve Board

[1] *American Bankers' Association Journal*, July 1933, p. 30, and *Bulletin of the American Institute of Banking*, 1933, pp. 362–6.

[2] Report of the Royal Commission on Banking and Currency in Canada, The King's Printer, Ottawa, 1933, p. 17.

TABLE II

BALANCE IN THE GENERAL FUND OF THE TREASURY

(in millions of dollars)

	June 30th, 1930.	June 30th, 1931.	June 30th, 1932.	June 30th, 1933.	April 13th, 1934.
In Treasury Offices	99	111	141	185	3,087
In Federal Reserve Banks	28	47	6	49	158
In Special Depositaries	297	413	406	837	1,774
In General and Limited (including Insular) Depositaries	27	28	27	31	31
In Treasury, Philippine Islands	—	1	1	1	1
In Foreign Depositaries	2	3	1	2	3
Total	454	604	581	1,104	5,054

Sources: Finance Reports, 1932, p. 427, and 1933, p. 365, and Treasury Daily Statement.

(formerly "the gold settlement fund"), and (since January 31st, 1934) the five per cent. redemption fund for Federal Reserve notes. On the other hand, it does include the amounts deposited for the five per cent. redemption funds against Federal Reserve Bank-notes and National Bank-notes and (until January 31st, 1934) for Federal Reserve notes. In fact, in the years 1930–33 the cash balance actually in the Treasury represented little more than the amounts of these redemption funds. The Treasury has always continued to receive and make some payments on Government account, but in those years its cash balance did not fluctuate widely. Thus no serious inconvenience was felt from this limited survival of the Independent Treasury system. Theoretically the complete abolition of the Independent Treasury would require the establishment of a branch of a Federal Reserve Bank at Washington to handle Government business, and the transfer of responsibility for the various reserve and redemption funds to the Federal Reserve Board. The recent trend has been very strongly in the reverse direction. We shall return to this point a little later.

At present "the greater part of the Government's receipts and disbursements are handled through the Federal Reserve banks and their branches," [1] according to the practice established during the War. The immense volume of business which the Reserve Banks do for the Federal Government is illustrated by the following facts:

> "During the year 1919 there passed through the federal reserve banks and their branches in round numbers thirty-three million government cheques, amounting to $14,500,000,000." [2]

The average Government deposits with the Reserve Banks in 1919 were $98·8 millions,[3] and their velocity of turnover was therefore about 147 for the year. Dr. W. R. Burgess in 1927 estimated the turnover of Treasury deposits with the Federal Reserve Banks at 300 times a year.[4] Government cheques drawn on the Treasurer's account are payable at any Federal Reserve Bank or branch. Though the bulk of them are no doubt presented through banks, they can be cashed by the payee in person if desired. Thus the Reserve Banks have the responsibility, from which the Bank of England is free, of satisfying themselves as to the identity of persons cashing Government cheques.

It is clear from the table above that in spite of the great amount of work which the Reserve Banks do for the Federal Government, they hold comparatively small Government deposits. This is not generally realised. It is still frequently stated, or implied, that the Federal Reserve Banks are gradually approaching the position of sole holders of the Government's cash balances.[5] On

1 Finance Report, 1931, p. 133.

2 Kemmerer, p. 109.

3 Annual Report of the Federal Reserve Board, 1919, p. 28.

4 Burgess, "The Reserve Banks and the Money Market," p. 91.

5 See *e.g.* F. C. James, "Money, Credit, and Banking," New York, 1930, p. 418; G. W. Dowrie, "American Monetary and Banking Policies," New York, 1930, p. 59, and H. G. Moulton, "The Financial Organization of Society," 3rd edition, New York, 1930, p. 569. Foreign writers perhaps may be forgiven for sometimes misinterpreting the elaborate depositary system of the United States. See *e.g.* Shaw, pp. 232–44, and Kisch and Elkin, pp. 36–8.

the contrary, the bulk of the Government balance at any given time is in the special depositary banks and the Treasury.

The comparative steadiness of the Government balance with the Federal Reserve Banks is due to a definite policy on the part of the Treasury. This was expressed in 1921 as follows:

"To keep down interest charges and avoid disturbance to the money market, the Treasury operates on a surprisingly small cash balance in the Federal Reserve banks. This balance is kept normally at around $25,000,000. To keep the balance as nearly as possible at such a figure requires constant vigilance on the part of the Treasury." [1]

So long as this balance does not fluctuate much, it is not a factor of importance in the money market. On this Dr. Burgess wrote in 1927:

"The item 'Government deposits' usually shows but little fluctuation and is maintained at a figure generally between 10 and 30 millions. Sometimes it runs above that amount, when the Treasury is receiving income taxes more rapidly than it disburses or reinvests the money, and on such occasions an increase in government deposits to 70 or 80 millions is frequently accompanied by firm money conditions because this money is drawn out of the money market. But this is a rare occurrence and ordinarily the item is an unimportant one." [2]

Government deposits with the Reserve Banks have fluctuated more widely from 1932 on account of the extraordinary Government transactions connected with the depression. For example, on June 30th, 1932, the Reserve Banks held (according to the statement of the Federal Reserve Board) $3·8 millions in Government deposits and at the end of July $57·4 millions.[3] The

[1] Finance Report, 1921, p. 389, from an address by Assistant Secretary of the Treasury Ballantine.

[2] W. R. Burgess, "The Reserve Banks and the Money Market," pp. 310–11.

[3] 18 *Federal Reserve Bulletin* (August 1932), p. 485. In the Treasury Daily Statements the figures are $28·7 millions and $80·1 millions respectively. These figures include items in transit and are perhaps not completely up-to-date, but it is still very strange that the differences are so great.

Treasury Daily Statement for December 21st, 1933, showed a balance of $220 millions in the Reserve Banks. Apparently a large balance was built up with the New York Reserve Bank to meet Reconstruction Finance Corporation disbursements, which did not take place quite so soon as was expected. This would have some tendency to produce firmness in the New York Money Market, since excess reserves were not so pronounced for the New York banks as elsewhere, but it was more than offset by other influences including moderate purchases of acceptances by the Reserve Bank.[1] In the two months following the devaluation of the dollar on January 31st, 1934, the total Government balance with the Reserve Banks varied between $308 millions on February 21st and $42 millions on March 12th, but it was usually around $125 millions to $150 millions, which may probably be regarded as the new normal level.[2]

Reference has already been made to the system of selling Treasury certificates of indebtedness to raise funds in anticipation of loans and taxes during and after the War. Loan certificates were not issued after 1922 until they were revived in 1932. From 1924 to 1931 these instruments were called simply certificates of indebtedness, and their purpose was essentially to anticipate the receipts from the Federal income tax, which was highly productive in this period.[3] The income tax is normally payable either in full on March 15th, or in four equal instalments on the quarter-days, the 15th of March, June, September and December.[4] The Treasury policy after the War was to arrange for all maturities and new issues of Government obligations and all payments of interest as far as possible to take place on these same

[1] *Monthly Review of the New York Federal Reserve Bank*, January 1934, p. 1.

[2] Treasury Daily Statements.

[3] Hendricks, pp. 278–9, 302–3.

[4] *Ibid.*, p. 282. The law provides, however, for the substitution for these dates of the 15th of the third, sixth, ninth and twelfth months of the year for which a business makes up its accounts. Thus, for example, many big department stores close their accounts on January 31st, and their tax payment dates fall a month later than the regular quarterly dates.

quarter-days. Evidently the intention was that payments for maturities and interest should be balanced by receipts from income tax, so as to minimise the disturbance to the money market.[1] New issues in this period, except for refinancing, were certificates of indebtedness to provide funds for use in the coming quarter. They were in the main taken by the commercial banks and paid for by credit in the manner already described.

This arrangement for concentrating Government transactions on the quarter-days was not so successful as might have been expected. Income-tax payments remained a source of disturbance, or at least of need for Central Bank offsetting operations, just as in England, though for different reasons. What happened at the quarterly tax date has often been described in the *Federal Reserve Bulletin* and elsewhere. The amounts due by the Treasury for maturities and interest were claimed by the commercial banks for themselves and their customers on the quarter-day itself. The tax cheques were mostly despatched on the quarter-day, paid into the Reserve Banks by collectors the next day, and credited to the Treasury one or more days later, according to the distance to the paying bank from the Reserve Bank concerned. Thus the Treasury paid out far more than it received on the quarter-days, and obtained funds for this purpose by temporary borrowing from the Reserve Banks. One-day certificates of indebtedness were issued to the Reserve Banks on the 15th to the amount of the overdraft required, and on each succeeding day a certain amount would be paid off from the proceeds of the income-tax cheques, whilst a fresh one-day certificate would be issued for the balance of the overdraft, until within about a week from the 15th it would be fully repaid. The bulk of the overdraft was always taken from the New York Reserve Bank, on

[1] Under-Secretary O. Mills in 1928 stated that "the taxes received in the Federal reserve banks are immediately paid out to the holders of the maturing certificates . . . and there is no disturbance in the money market." Revenue Act of 1928, U.S. Senate Hearings, pp. 271–2, quoted by Hendricks, p. 281.

account of the large proportion of maturities of expiring issues presented for payment through the New York commercial banks.

This Treasury overdraft at the Reserve Bank added to the reserve funds at the disposal of the New York Money Market, and would tend to cause a temporary lowering of rates through pressure of short-term funds seeking employment. As a rule, this tendency was offset by the temporary reduction of Reserve Bank credit outstanding by various devices, including a reduction of rediscounts by member banks and a sale of securities by the Reserve Bank. Thus, for example, on March 15th, 1927, the net result of operations carried out by the New York Reserve Bank for the Treasury was a gain of $265 millions of reserve funds by the New York Money Market,

> "because payments by the Treasury to redeem maturing notes and to pay interest were immediately available, whereas the actual collection of income-tax cheques . . . was spread over a number of days."

The offsetting influences on that day were:[1]

(1) $85 millions was absorbed in restoring member banks' reserves to the required average up to date in the week, as they had allowed them to run down for a few days previously.

(2) $63 millions was repaid by member banks to the Reserve Bank.

(3) $18 millions of Federal Reserve credit was retired by decreasing the Reserve Banks' holdings of bills and Government securities under sales contract.

(4) $60 millions, out of the special one-day certificate for $238 millions issued by the Treasury to the Reserve Bank, was sold to member banks.

(5) Maturities of $25 millions of the Government securities in the Federal Reserve Banks' joint open market account (which are lodged in New York) were not replaced until the following week.

[1] *Monthly Review of the Federal Reserve Bank of New York*, April 1927, pp. 26–7.

These items account altogether for \$251 millions out of the \$265 millions, so that the net actual gain to the New York Money Market was not large. The Federal Reserve Board stated that

> "as a result of the absorption by the reserve banks of the surplus funds arising from the Treasury disbursements, the period passed with but little decline in the level of open-market money rates."

The sale of participations in the special one-day Treasury certificate was a new kind of security sale to withdraw funds temporarily from the market. The Federal Reserve Board commended this device, stating that it

> "avoids many bookkeeping complications involved in a temporary sale of securities from the system's investment account and appears to be a simple and direct way of offsetting surplus Treasury disbursements." [1]

Evidently the special certificates carry a fair rate of interest in relation to market rates or the commercial banks would not care to take them.

In view of this, it is surprising to find the Federal Reserve Bank of New York asserting that on March 15th, 1930, it was not possible to offset the excess Treasury disbursements because the member banks were "practically out of debt at the Reserve Banks," whereas

> "under ordinary circumstances . . . they employ the free funds made available by the Treasury in the reduction of their indebtedness for a few days."

The result was a large temporary fall in money-market rates of interest. It does not appear that there was any special reason to prevent the Reserve Banks from selling securities if they wished to prevent this fall.[2] In September 1930 the New York Reserve Bank "largely averted" a threatened surplus of funds in the market from Treasury

[1] 13 *Federal Reserve Bulletin* (April 1927), p. 250.

[2] *Monthly Review of the Federal Reserve Bank of New York*, April 1930, pp. 25–6.

operations, by selling participations in the special one-day Treasury certificates.[1] Again on March 15th, 1931, one-day Treasury certificates issued to the Reserve Banks totalled $170 millions, but out of this total certificates for $106 millions were resold by them to member banks in New York and Boston. Government securities worth $37 millions were also temporarily sold from the System's investment account.

> "By the use of these methods, the temporary accession of reserve funds to the member banks was considerably reduced and the period was passed with little fluctuation in money rates."[2]

It is interesting to find that in 1932 the necessity for a Treasury overdraft on the quarter-days disappeared, as an accidental result of the extraordinary conditions under which Government borrowing has been carried out during the depression. Income-tax receipts became very much smaller. Securities maturing on a given date were mostly exchanged for new issues instead of being presented for payment in cash. The artificial plethora of cash created by the decline in investment, together with Federal Reserve open-market operations, resulted in a fairly large percentage of cash payments for the new Government issues which provided funds for cash outgoings on the quarter-days. Thus on June 15th, 1932, the Treasury closed its books with a small credit balance at the Reserve Banks instead of an overdraft, whilst on September 15th, 1932, "the Treasury . . . actually had larger credit balances at the Reserve Banks . . . than on the previous day."[3] In view of the general policy of increasing the pressure of excess reserves in the member banks in order to produce credit expansion, there would presumably be no desire to offset any increase in excess reserves that might result from Treasury operations during the depres-

[1] *Monthly Review of the Federal Reserve Bank of New York*, October 1930, p. 73.

[2] 17 *Federal Reserve Bulletin*, April 1931, pp. 181–2.

[3] *Monthly Review of the Federal Reserve Bank of New York*, 1932, pp. 50, 74.

sion.[1] There has also been some tendency to lessen the concentration of Government operations at the quarter-days.[2] Out of \$8·1 thousand millions now outstanding in Treasury certificates and notes, an amount of \$5·3 thousand millions falls due on the regular quarter-days.[3]

During the years of prosperity the Treasury became dissatisfied with the working of the certificate system of financing. Besides the objections already quoted in connection with the special depositary system, the Secretary of the Treasury mentioned in 1929 the following objections:

> (1) At the quarterly tax periods the Treasury has to borrow from the Federal Reserve Banks and pay interest on this temporary borrowing as well as on the newly issued securities.
>
> (2) It is difficult for the Treasury to adjust accurately the fixed coupon rate on certificates to current market conditions.
>
> (3) The issue on certain fixed dates does not permit the Treasury to take advantage of easy money conditions that may arise at other times.[4]

To these we may add the further objection arising from the experience of the depression period, that calling for applications on a fixed-interest basis at a time of strong demand for the certificates results in padded applications and makes it hard to decide on a fair and rational system of allotment. Dr. Hendricks has pointed out that there

[1] *Monthly Review of the Federal Reserve Bank of New York*, January 1934, p. 1. The Treasury operations of December 15th, 1933, produced an increase of excess reserves for the New York member banks, which was not offset.

[2] Issues of certificates and notes mainly intended to raise funds for the Treasury to advance to the Reconstruction Finance Corporation were often not connected with the quarter-days. See *Federal Reserve Bank of New York Monthly Review*, 1932, pp. 13, 36, 60; cf. also p. 20 for a special issue on February 1st.

[3] From the figures for the various issues in *New York Herald Tribune*, April 24th, 1934, p. 32. None of the outstanding issues of Treasury bills falls due on a regular quarterly date.

[4] Finance Report, 1929, p. 40.

was no legal obstacle to an attempt by the Treasury to remodel the certificate system, so as to overcome the various difficulties.[1] The Treasury, however, chose not to attempt any radical reorganisation of the existing system, but to supplement it by getting Congress to authorise the sale of Treasury bills. These are allotted to persons tendering at the lowest rates of discount, according to the system that has been followed in England for sixty years.[2] They usually run for ninety to ninety-two days, but from February 1934 some have been issued to run for 182 days. Until then payment was always required in current funds, but payment by credit under the special depositary system was permitted for the 182-day bills.[3] Tenders for the bills are made and opened at the Reserve Banks. It is said that the Reserve Banks themselves are the chief market for Treasury bills.[4]

The Secretary of the Treasury announced in 1929 that it was not intended

> "to replace the old system, but rather to continue the issue of certificates of indebtedness for . . . regular short-term financing, supplementing with the issue of small amounts of Treasury bills when the need for funds between quarterly dates arises and the condition of the money market is propitious."

He seems therefore to have been much too optimistic in his statement of the advantages to be expected from the use of Treasury bills.[5] In fact, they have been used in the depression period merely to effect a certain volume of Government borrowing at a low rate, and at maturity have been regularly replaced by fresh issues or by Treasury notes.

The earliest issues of Treasury bills did not prove cheaper than certificates. The reason was that gains and

[1] Hendricks, pp. 299–300.

[2] Sir Ernest Harvey told the Macmillan Committee that the American authorities consulted the Bank of England and studied carefully the working of the Treasury bill system in England before adopting it. (Qn. 454.)

[3] *Federal Reserve Bank of New York Monthly Review*, March 1934, p. 21.

[4] H. P. Willis and others, "The Banking Outlook," p. 875.

[5] Finance Report, 1929, p. 41.

losses on resale were to be accounted for in calculating income tax, and holders had to keep records of all their transactions, though the difference between gains and losses would never be of much importance. At the request of the Treasury, Congress amended the law in June 1930, so as to remove this obstacle.[1] After that Treasury bills became very popular, and the Government saved a good deal of interest in so far as it used them instead of certificates. The discount rate on Treasury bills has almost invariably been lower than the interest on certificates, and generally by an amount varying between 0·5 and 1·5 per cent.[2] From 1932 the rates on Treasury bills have sometimes fallen to quite a nominal figure, so that the Government practically borrows free of interest. For example, some of the bids for the ninety-one-day bills to be issued on April 25th, 1934, are on a discount basis of about 0·05 per cent. per annum, and the whole series is being placed at an average rate of about 0·08 per cent. per annum.[3]

It seems clear that the use of Treasury bills so far has been advantageous to the Government chiefly in the saving of interest. There is scope for much more use to be made of them. As normal conditions of prosperity return and Government transactions decline to their former level, the Treasury might do well to drop certificate financing and keep the whole of the floating debt in the form of Treasury bills. It would appear at first as if this might make the special depositary system unnecessary, and the Treasury might rely solely on manipulating the volume of Treasury bills outstanding, to keep down its balance with the Reserve Banks during the tax periods. The issues of three-months Treasury bills can be adjusted

[1] Finance Report, 1930, pp. 22–3.

[2] See the chart given by Dr. Hendricks, *op. cit.*, opposite p. 307.

[3] *New York Herald Tribune*, April 24th, 1934, p. 31. On May 15th, 1934, an issue of ninety-one-day Treasury bills was allotted at an average rate of discount of 0·06 per cent. per annum, and a part of it was actually tendered for and allotted at par, so that the Government borrowed that amount free of interest. Possibly the tender was a joke. See *New York Herald Tribune*, May 16th, 1934.

so as to keep down Government balances in England, because the peak in tax payments comes only in one quarter of the year and the volume of bills outstanding can be reduced then. But this method would not work in the United States, because most of the income-tax payments are concentrated in the week or so of each quarter following the regular quarterly dates (15th March, June September and December). If Treasury bills were paid off from income-tax receipts just after March 15th of any year, and no fresh ones issued at that time, there would be no maturities that could be paid off in the next tax period just after June 15th. Thus it is clearly just as impossible to adjust Treasury bills outstanding, so as to offset regular quarterly payments of income tax, as it is to adjust for this purpose certificates or any other instruments that run for three months or a multiple thereof. The period of usance would have to be changed in order to do this.

The real connection between certificate financing and income-tax receipts in the decade of prosperity 1921–30 lay only in the fact that surplus receipts could be used to reduce the public debt by permanently retiring certificates. Suppose that there were no surplus, and that at the quarterly tax period \$500 millions of tax receipts paid off \$500 millions of certificates, whilst \$500 millions of fresh certificates were issued, and the proceeds left in special depositaries to be drawn down gradually to cover expenditure in the ensuing quarter. Essentially this is equivalent to leaving the tax proceeds in the banks until they are needed for expenditure, and allowing the certificate transactions to cancel out. It would be quite immaterial when the certificates fell due, so long as new certificates to the same amount were paid for in cash, so that the cash received and paid out by the market would balance. The simplest and best remedy for the lack of exact synchronisation between certificate maturities and income-tax receipts would have been to apply the special depositary system to the tax receipts, and not to the payments for certificates.

The income tax is already becoming more productive than it was in the depth of the depression. Presumably it will again in course of time be the mainstay of Federal Government finance, and the quarterly payments will be large enough to cause a considerable disturbance in the money market if they should be paid to the Reserve Banks without any offsetting influence. The obvious remedy is to leave the tax receipts in the special depositary banks till they are needed for disbursement. This was done for a short time in 1918, and the practice then followed has been described on p. 148 above. The Government could perhaps now go further than merely redepositing the cheques received, and allow payment by credit as it has done for so long in regard to securities. The practical effect would be the same either way. The particular technique to be employed would be a matter of administrative convenience, and could be modified according to experience.

The floating debt could probably best be kept altogether in the form of Treasury bills, with frequent tenders and daily maturities along the lines of the British system. This should be a flexible and effective means of adjusting the Government's balances in the Reserve Banks to fluctuations in expenditure. Experiment might be made with maturities intermediate between the usual three months and six months. The volume of bills should be kept at a reasonable and fairly high average level, so as to provide for the needs of the banks for that type of investment. Surplus revenue could then readily be used to retire floating debt temporarily, until an opportunity should arise to restore its level from maturities of longer-term debt. The Treasury bills could normally be paid for, as now, with current funds. It would probably not be necessary to use the system of payment by credit for securities in normal times when the public debt is being gradually reduced. However, the special depositary organisation would be there in case special reasons should make it advisable to use it for a particular issue, and it would be ready to resume its old functions if any

emergency should again make it necessary for the Government to borrow on a large scale.

Since special depositary banks no longer pay any interest on Government deposits, there is no reason why they should be given any notice of withdrawal. They could not object to losing a reasonable amount of these deposits through the clearing without notice, just as with other demand deposits. However, it seems possible to arrange for the funds not to be withdrawn till corresponding disbursements have actually been made by the Reserve Banks. This would avoid any possible strain except in the form of ordinary clearing losses as between the different banks and districts. The normal level of Government deposits with the Reserve Banks could be fixed at some reasonable amount—say, for example, $150 millions—and the Federal Reserve Board could be empowered to make up a deficiency by ordering clearing debits to the special depositaries in proportion to their respective Government deposits. The total amount that might be so debited on any one day would be limited to some reasonable figure, so that the depositary banks need not fear undue disturbance. The Treasury would still have to look ahead, and decide from day to day whether the expected disbursements could be adequately met in this way, or whether Treasury bills should be issued in order to keep up its balances in the Reserve Banks. Transfers between Reserve Banks would also still be made when necessary by the Treasury, so as to keep the balance with each Reserve Bank in line with requirements.

As already suggested, the rather clumsy system of requiring collateral security for Government deposits should be abolished and, if necessary, the Federal Government could be made by law a prior creditor of all banks to the extent of its deposits. All Government deposits should be subject to the usual reserve requirements. It is to be hoped that before long the banking system of the United States will be unified so that all commercial banks are chartered by the Federal Government and are members of the Federal Reserve System. There need then be no

question of separately designating special depositaries; all member banks might well be authorised and required by law to act as special depositaries. Possibly the Federal Reserve Board might be given discretion to disqualify a member bank from holding Government deposits, so long as the bank refused to give up practices which the Board considered unsound or undesirable in view of the general credit situation. This would be one method of strengthening the control of the Federal Reserve authorities over the member banks, but that control has perhaps already been adequately provided for by the Banking Act of 1933.

On the whole, we may conclude that there has been considerable progress in the United States in the evolution of a depositary and fiscal agency system for the Federal Government suited to the special needs and circumstances of the country.[1] The mode of transacting most Government business through the Federal Reserve Banks and branches is very efficient and convenient. The regular depositary banks (general and limited) provide additional

[1] Nothing has been said here about "Public Deposits" of funds belonging to the various States of the Union and their sub-divisions. Each State makes its own arrangements. Many States, especially in the South, formerly used Independent Treasury systems of their own. In recent years the tendency has been to deposit the funds in banks and take some kind of collateral security or surety bond. A minimum rate of interest on the deposits was often prescribed by State law, and in some cases deposits were placed with banks offering the highest rate of interest on competitive tenders. (See Chapman and Westerfield, "Problems in Banking, Money and Credit," New York, 1927, pp. 569–70.) So far as State deposits are demand deposits, it is now illegal for member banks of the Federal Reserve System to pay interest on them (Section 11*b* of the Banking Act of June 16th, 1933). It is sometimes suggested that States should be allowed to open accounts with the Reserve Banks. This would mean that State business would then be done in reserve funds, and would at times withdraw funds from or pour them into the money market. A better solution seems to be a strong, unified banking system such that the States could safely keep their funds with the commercial banks. To induce them to dispense with collateral security, they might then if necessary be given, after the Federal Government, a prior claim on the assets of banks to the extent of their deposits, on the lines of the Canadian arrangement already mentioned.

facilities for Government cash transactions in places that are not near a Federal Reserve Bank or branch. Their Government accounts correspond roughly to the local banking accounts which revenue collectors and paymasters keep with branches of the commercial banks in England. Since the elimination of "inactive accounts" in 1920, the regular depositaries have formed a stable and accepted element in the system. The suggestion made above, for dropping collateral security and imposing normal reserve requirements, applies just as much to the regular as to the special depositaries. Other suggestions have also been put forward above for improving the working of the special depositary system in normal times. The special depositaries have proved their great usefulness as a means of transferring fluctuations in Government balances from the Reserve Banks to the commercial banks. But it seems doubtful whether they were used in the best possible way in the decade 1920–30. A modified use of the special depositaries, along with short-term financing solely through Treasury bills, seems to offer the best prospect of a smooth adjustment of Treasury operations to general money-market conditions in the next prosperity period.

We pass now to the question of the general relations between the Federal Government and the Federal Reserve Board, and the influence of the Treasury on credit policy. The Secretary of the Treasury, as an ex-officio member and Chairman of the Board, was no doubt intended to have considerable influence. But the relations between the Treasury and the Board were not carefully defined. It was necessary to obtain in December 1914 a ruling from the Attorney-General on the status of the Board. He decided that the Board was an "independent bureau or establishment of the Government," and not under the jurisdiction of the Treasury Department. Many people expected the Board to have the status of a "Supreme Court of Finance," but these hopes were disappointed. Professor H. P. Willis, who was the first Secretary of the Board, has made it clear that the Treasury was practically

in control from the first, and was hostile to the development of a really independent and responsible position for the Board. "It was probably true," he says, "from the very beginning, that the Secretary of the Treasury could secure a practical majority for any measure or policy that he might choose to advocate." The Board tended to become "a regular routine bureau or office organised and operated like other government bureaus." Secretary McAdoo insisted on having the Board's office in the Treasury building. The Board became "more and more dependent upon Treasury dictation and . . . in fact, even if not in theory, a portion of the organisation of the Department." President Wilson took the view that he should not interfere with the Board, but in practice the result was that the Secretary of the Treasury exercised a large measure of control, against which there was ordinarily no appeal.[1] This arrangement did not work smoothly, and friction between the Treasury and the Board prevented the making of proper financial preparations beforehand for America's entry into the War.[2]

The arrangement that the members of the Federal Reserve Board should all be politically appointed was a concession made to the Bryan wing of the Democratic Party during the passage of the Federal Reserve Act. The fear that this would mean that politics could not be kept out of the Reserve System, and that the best men would not be appointed, seems to have been justified. Professor Laughlin admits that there have been "some competent men" on the Board, but states that "men of the best possible training and experience in banking and credit were not obtained when the method of choice was political." He is very scornful of the amendment of 1922 adding an extra member to the Board in order to make room for a "dirt farmer," and he adds that "there is even now one Senator, an adept in political brokerage, who has put his own favourites on the Board, men who have practically no insight into banking; and presidents

[1] Willis, "The Federal Reserve System," pp. 618, 672–4, 796–9.
[2] *Ibid.*, pp. 832–6.

have appointed them." He proposes that the President's field of selection should be limited to trained bankers and economists.[1] In 1922 Mr. Paul Warburg, probably the most distinguished of the original members of the Board, also emphasised strongly the dangers to the System from politics and from the politicians who want "open doors for patronage and a ready compliance with the wishes of their constituents."[2] "Political influence," he asserts, "has had the effect of driving from the Board desirable members, and of preventing the service on the Board of many a man who might have been admirably qualified for the task." His proposals for reform are as follows: (1) the Secretary of the Treasury should be replaced on the Board by the Under-Secretary, (2) the office of Comptroller of the Currency should be amalgamated with the Board, (3) the Governor and Vice-Governor should be elected by the Board, and not appointed by the President, and the Governor should preside at meetings, (4) more expert bankers should be appointed, and (5) the President should be empowered to renew a member's appointment without any need for fresh confirmation by the Senate.[3] Professor Willis points out that the system has been free from political influence in the sense of pressure to make particular loans. But he agrees that it has never been free from it in the sense of efforts "to shape policies either in the interests of given classes, or in the interests of . . . conditions favourable to particular kinds of business."[4]

The outbreak of War in 1917 made the Treasury more willing to use the Reserve System, and everyone admits that Treasury control was completely dominant in the War period and up to the end of 1919. Professor Willis

[1] G. L. Laughlin, "The Federal Reserve Act, its Origins and Problems," New York, 1933, pp. 215–17.

[2] P. M. Warburg, "Political Pressure and the Future of the Federal Reserve System," in *Annals of the American Academy of the Political and Social Sciences*, January 1922, pp. 70–4.

[3] Warburg, "Federal Reserve System," New York, 1930, Vol. II, pp. 843–54.

[4] Willis, "The Federal Reserve System," pp. 1500–01.

says: "The system found itself increasingly forced into the position of a mere adjunct of the Treasury. The Board lost power and finally ceased largely to exert authority except in serving to carry out Treasury instructions." [1] In the summer of 1917 "the Board was, in spirit at least, sharply opposed to much that Secretary McAdoo had in mind . . . (and) a firm but positive protest was lodged against the borrowing plans of the Treasury." Secretary McAdoo's reply was a threat to take over the gold reserves and "the entire funds of all the banks for the purpose of winning the war." As the members of the Board could not bring themselves to resign at that time, there was nothing to be done but to acquiesce in the Treasury policies, and in every way possible try to mitigate their harmful effects. The Treasury showed a tendency to ignore the Board and send instructions direct to the Reserve Banks, and Secretary McAdoo supported the Reserve Banks in a movement for higher salaries to which the Board was opposed. The Board reluctantly adopted the policy of low rediscount rates equal to the interest on Government securities, because "the Treasury Department was in position to override the Board . . . with the assistance of the reserve banks." [2]

"Owing to the exigencies of Treasury financing, the War-time Federal Reserve rate of four per cent. was not advanced until November 1919," in spite of the rapid advance in market rates from July.[3] Professor Sprague says that the unpopularity which befell the Federal

[1] Article on the "Federal Reserve System" in the *Encyclopædia of the Social Sciences*, 1931, Vol. VI, p. 158.

[2] Willis, "The Federal Reserve System," pp. 1154–5, 1204–5, 1210, 1284. Governor Benjamin Strong of the New York Reserve Bank regarded the Bank as being the "agent and servant" of the Treasury for those matters as to which the law gave the Secretary of the Treasury power to require the Reserve Banks to act as fiscal agents. See "Interpretations of Federal Reserve Policy," ed. W. R. Burgess, New York, 1930, p. 86.

[3] 7 *Federal Reserve Bulletin* (August 1921), p. 895. It appears that rates would probably have been raised in April, but for the position of the Treasury. See "The Formative Period of the Federal Reserve System," by Governor W. P. G. Harding, p. 148.

Reserve System in the years 1920–22 was the result of the "low discount policy which the Treasury Department unwisely insisted must be continued for more than a year after the Armistice,"[1] as this facilitated the post-war boom, and thus aggravated the ensuing depression. However, it was the high rates of 1920–21 that were really unpopular. In the presidential election campaign of 1920, both sides more or less committed themselves to lower rates in case of success. Rates were, in fact, reduced from May 1921, soon after President Harding took office, and the Administration spokesmen claimed credit for it. President Harding's appointments to the Board were generally held to mark a deterioration, "since they clearly revealed the entry of political considerations of a controlling character in the selection of personnel." These developments were frequently referred to as the introduction of politics into the Federal Reserve System.[2]

In 1921–22 the Treasury put strong pressure on the Federal Reserve authorities to pay out gold certificates, on the ground that an unrestricted gold standard required the domestic circulation of gold. The Reserve Banks were instructed for some time to pay gold certificates for denominations of $20 or more in making current payments for the Government and in exchanging or redeeming United States currency. Also when the Reserve Banks bought securities in 1921–22 in order to earn expenses and pay dividends, the Treasury took objection to large purchases of Government securities by the Reserve Banks, since they "tended to obscure the condition of the

[1] *Annals of the American Academy of the Political and Social Sciences*, January 1922, p. 221.

[2] Willis, "The Federal Reserve System," pp. 1417, 1478–9, 1484–5, 1490, 1494. Prof. Willis says that President Harding "appointed a Governor of the Federal Reserve Board who was without experience, knowledge or training suited to the task, and whose chief claim upon the position was his acquaintance with the President himself," and that he "sent to the Governor of the Reserve Board a local politician of a Western state to announce that he had been promised by the Executive the chairmanship of a Reserve Bank for political service. . . . during the campaign." See *Bankers' Magazine* (New York), January 1925, p. 16.

investment market." [1] All this makes strange reading to-day!

There has been some disagreement as to the extent to which the Federal Reserve Board was able to free itself from Treasury domination after 1919. Professor Willis strongly maintains that the Treasury's interest in cheap money continued to be the most important factor shaping the Board's policies. Thus Professor Beckhart and he say:

> "There has been steady tinkering on the part of the Treasury department with the discount rate in the effort to keep it low, and hence to facilitate the floating of new Treasury obligations, while there has been equally steady effort on the part of the Treasury to control and direct the actual policy of reserve banks." [2]

In 1927 Professor Willis wrote as follows:

> "It was President Coolidge who in his last pre-election speech [1924] definitely stated that it had been the consistent policy of the Administration to enforce cheap discount rates, and added that the policy would be continued. No changes of rate have been made at Federal Reserve banks without consulting the needs of Treasury finance as a fundamental prerequisite. . . . It should, of course, be needless to say that any and every central banking system worthy of the name will and does invariably give the utmost consideration to the necessities of the government under which it is living, but that is a matter very different from accepting the wishes of such a government for ultra-cheap money as a guiding factor. A policy of such acceptance was, however, established during the War, and the Federal Reserve system has never been wholly able to throw it off." [3]

He referred in 1928 to the existence at times of

> "an alliance between the Treasury Department and one or two of the reserve banks, the department giving orders directly to these

[1] S. E. Harris, "Twenty Years of Federal Reserve Policy," Vol. I, pp. 159, 353–5.

[2] Willis and Beckhart, "Foreign Banking Systems," 1929, p. 15.

[3] *Journal of Commerce*, March 8th, 1927, p. 6. Elsewhere Prof. Willis writes: "The system had from the outset subjected itself to tendencies and conditions which worked toward the conversion of it into a branch or agency of any administration which happened to be in power." See H. P. Willis and others, "The Banking Outlook," p. 670.

reserve banks and practically leaving the board aside as a kind of fifth wheel." [1]

And in 1929 he wrote:

"While Reserve bank directors were in session in this city [New York] a week ago, one of the great obstacles to their taking definite action designed to correct the present situation was said to be the effect of such action upon the Treasury Department." [2]

Another writer says:

"The politically appointed Federal Reserve Board . . . is . . . tied in very closely with Government affairs. The power to establish rediscount rates . . . inclines more and more to the Board rather than to the Reserve Banks. During the War and since, the exigencies of Government financing have often been the determining factors in the policies of the Board of keeping the level of rediscount rates below that of the general market." [3]

Of course it is very difficult to get any first-hand information on this subject, as the persons directly concerned may not be able to speak freely. Governor Harrison in 1931 denied that in recent years there had been any effort by Treasury officials to influence the rate policy or operations in Government securities of the New York Reserve Bank.[4] Dr. A. C. Miller, an original member of the Federal Reserve Board, said in 1928: "There is a constant disposition not to work at cross purposes, but to let the Treasury's programme, whenever

[1] *Journal of Commerce*, May 17th, 1928, cited in "Stabilization Hearings," 1928, p. 316. Prof. Willis also says: "In important cases, Reserve banks themselves have at the instance of their more influential members allowed themselves to become the medium for representations to the Treasury Department in favour of undue leniency towards banks that were engaging in illegal or undesirable operations." See "The Banking Outlook," p. 670.

[2] *Journal of Commerce*, March 8th, 1929, p. 4.

[3] Howard Whipple in the *American Bankers' Association Journal*, August 1933, p. 49. Cf. also the article by Prof. H. P. Willis on "Politics and the Federal Reserve System" in the *Bankers' Magazine* (New York), January 1925, pp. 13–20.

[4] Hearings before the Senate Committee on Banking and Currency on Senate resolution 71, 1931, Part I, pp. 98–9.

it is practicable, work in with the Federal reserve's." This was in reference to Treasury purchases for reduction of the public debt and Federal Reserve open-market operations.[1] Dr. Miller was in favour of not having any ex-officio members on the Board. He indicated that they do not have time to give thorough consideration to its business, and yet are apt to have the decisive influence when the Board is divided, or when some members are wavering and inclined to follow the lead of the Secretary of the Treasury.[2] The Glass Bill of 1932 provided for the removal of ex-officio members from the Board, but this provision was eliminated before it was enacted as the Banking Act of June 16th, 1933.

Mr. C. O. Hardy has concluded, from a comparison of the dates of rate changes at the New York Federal Reserve Bank with those of new issues by the Treasury, that there is no obvious relationship. Similarly, he finds that the Reserve Banks have not timed their open-market purchases so as to help the Treasury float new issues cheaply. On the general question of Treasury influence he says: "Certainly if there has been a dominant purpose to help the Treasury borrow cheaply, the policy has been carried out very ineffectively."[3] Different conclusions are indicated by Dr. H. G. Hendricks in regard to rate changes. Taking a broader view than Mr. Hardy, and looking at periods of a year or two when large refunding issues were made, 1922–23, 1927–28, and 1930–31, he finds that these were all periods when rates were lowered, and that in 1923 and 1928 they were put up again, but only when the Treasury had nearly completed its task. It seems difficult to avoid the conclusion that Treasury needs were still being given great weight. As regards Government security holdings, Dr. Hendricks agrees with Mr. Hardy that the Reserve Banks have not

[1] "Stabilization" Hearings before the House Committee on Banking and Currency on H. R. 11806, 1928, p. 264.

[2] *Ibid.*, pp. 322–3.

[3] C. O. Hardy, "Credit Policies of the Federal Reserve System," pp. 282–7.

in general increased them at the time of new issues by the Treasury. He shows, however, that when $2\frac{7}{8}$ per cent. Treasury notes were issued in April 1933, the Reserve Banks improved the market for them by replacing other types of Government security in their portfolios by Treasury notes, though without any increase in their total holdings.[1] Of course the huge open-market purchases of Government securities by the Federal Reserve Banks in 1932 and 1933 have fitted in very conveniently, when taken as a whole, with the great increase in Government borrowing. But for the period 1920–31 it seems to be true that the volume of the Reserve Banks' holdings of Government securities was not varied in such a way as to help in absorbing the Treasury's new issues.

On the whole, even for the decade of the 'twenties, the indications are that Treasury needs still played a considerable part in the shaping of Federal Reserve policies. Though estimates of the importance of this factor are bound to vary, there can hardly be any real doubt that until 1928 the Treasury exercised a fairly strong general influence in the direction of cheap money,[2] and it is also likely that the level of discount rates near the times of large Treasury operations was directly affected by the desire to finance the Government at low rates. At various times from 1923 to 1927 President Coolidge and Secretary Mellon assured the public that the business and stock-market activity was healthy, and that low discount rates and prosperity would continue. Mr. R. W. Robey suggests that these statements were largely responsible for the Stock Exchange boom.[3] It seems obvious that,

[1] Hendricks, pp. 294–7.

[2] Mr. Edmund Platt (former Vice-Governor of the Federal Reserve Board) states that Secretary Mellon voted for higher rates in 1928–29, and that from 1920 to 1930 Mr. Mellon never attempted "to prevent increases of rates or to favour decreases with any reference to Treasury financing." See Mr. Platt's letter in the *New York Times*, March 19th, 1934. This does not seem to disprove the existence of a general Treasury influence in favour of cheap money till 1928, but shows that it was not necessary to exert it in any crude or obvious way.

[3] R. W. Robey, "Capeadores in Wall Street," *Atlantic Monthly*, September 1928.

whilst it was committing itself to such definite assertions and prophecies, the Administration could hardly refrain from influencing the Federal Reserve authorities to adopt the same views and justify at least the prophecies of low discount rates. A very good comment on this general attitude is the following by Mr. Paul Warburg:

> "There is nothing more dangerous for the Federal Reserve System and for the country as a whole than to have party administrations claim credit for low discount rates and easy money . . . because it is bound to interfere with the non-political and judicial point of view, which is the only one that should guide an independent and self-respecting Federal Reserve Board." [1]

It is generally believed that the Presidential election of November 1928, and the consequent desire of the Administration to avoid anything unpopular, were largely responsible for the failure to take adequate steps to check speculation at that time.

Whatever view may be taken as to the intervening period, it is quite clear to everyone that from 1932, and more especially since the "New Deal" of 1933, the Government has again taken firm hold of the controls in the machinery of money and banking, and is imposing its will on the Federal Reserve authorities even more drastically than during the War period. The open-market operations of the Reserve Banks have been persisted in, although it was clear that they were only building up excess reserves which the member banks were not inclined to put to active use. Government securities held by the Federal Reserve Banks rose from about \$0·6 thousand millions to \$1·85 thousand millions between March and August 1932, whilst a further movement in the second half of 1933 brought them nearly to \$2·5 thousand millions.[2] This was all part of the Government's policy of trying to start a credit expansion. By the Thomas amendment to the Farm Relief Act of May 12th, 1933, Congress practically gave the President power to order

[1] Warburg, "The Federal Reserve System," Vol. II, p. 852.
[2] *Federal Reserve Bulletin, passim.*

purchases of Government securities by the Reserve Banks to the extent of $3 thousand millions. Nominally he was empowered to direct the Secretary of the Treasury to make an agreement with the Reserve authorities, but they could hardly refuse to agree if asked, as power was also given to the President to issue up to $3 thousand millions of United States notes, if other methods of bringing about expansion should fail.[1] The actual resumption of open-market operations was soon announced by the Treasury, which spoke of the Reserve Banks having been " authorised " to buy more Government securities. One journal commented that " the Federal Reserve authorities . . . can act only in response to the dictation coming to them from higher up."

> " The Federal Reserve System (said the same journal later on) cannot be held as otherwise than in peril so long as its sole function appears to be to act as an adjunct to the U.S. Treasury to take over large masses of U.S. securities." [2]

The commercial banks, of course, have also been absorbing large quantities of Government securities without any direct compulsion. In February 1934 it was said:

> " Already the banks have more than 50 cents of government securities for every dollar of demand deposits. Government depositaries is the name to apply to them—that is the place where the government deposits securities." [3]

The open-market operations of the Federal Reserve Banks have greatly increased the reserves of the commercial banks, and the Treasury borrows at artificially low rates, because of the influence of these excess reserves on the investment policy of the banks.

It has been estimated that one-third of the national income of the United States was distributed through Governmental channels in 1933, and that approximately

[1] 19 *Federal Reserve Bulletin* (May 1933), p. 317.

[2] *Commercial and Financial Chronicle*, May 27th, 1933, p. 3579, and September 30th, 1933, p. 2313.

[3] *New York Times*, February 27th, 1934, p. 21.

forty per cent. will be so distributed in 1934.[1] These figures may be too high, but they indicate the extent of Government action in the economic sphere. One of the major instruments of the Government in its emergency programme is the Reconstruction Finance Corporation, which was established in January 1932. All the funds used by the Corporation are advanced by the Treasury, which raises them by selling its own obligations. The Corporation lends money to financial institutions and railroads and for various projects of specified kinds. It also allots funds to several other Government agencies and for relief expenditure. Its main object at first was to help the banks by advancing cash on sound assets. More recently it has been buying preferred stock and capital notes and debentures of banks in order to strengthen their capital structure, and over $800 millions was allotted under this head by the end of 1933. This is regarded by some as the beginning of nationalisation of the banks. Much financing that in normal times would be done through bank loans or security issues has been done through R.F.C. loans. The total amount allotted by the R.F.C. to the end of 1933 was about $6 thousand millions, of which about $1 thousand millions had been repaid and some $2 thousand millions was awaiting disbursement.[2]

> "Federal Reserve purchases of Government securities necessarily were conducted largely in New York, but the funds paid out were largely distributed through Treasury transfers of funds to other parts of the country to cover payment of loans made by the R.F.C., as well as ordinary Government expenditures." [3]

Dr. Harris states that the R.F.C. loans to banks in the West and the South in 1932 enabled them to accumulate balances in New York, which they withdrew in the crisis that led to the bank holiday of March 1933.

[1] *Commercial and Financial Chronicle*, April 14th, 1934, p. 2460. The estimates are by the Durable Goods Industries Committee working under the National Recovery Administration.

[2] 19 *Federal Reserve Bulletin* (December 1933), p. 735, and 20 *Federal Reserve Bulletin* (February 1934), p. 103.

[3] *New York Federal Reserve Bank Monthly Review*, April 1932, p. 25.

"Thus the East, in purchasing securities sold by the Treasury, which made possible the attempts of the R.F.C. to bolster up the financial position of the West and South, also contributed to its own undoing when these banks later were forced to strengthen their position at the expense of the New York banks: the out-of-town banks preferred their surplus reserves in the midst of the crisis." [1]

The most important action taken so far during the emergency in the hope of improving the working of the banking system is the guarantee of deposits through the Federal Deposit Insurance Corporation provided by the Banking Act of June 1933. At present a provisional scheme is in force by which deposits are insured up to a maximum of $2,500 in each account. There is considerable opposition to bringing into effect the full scheme intended by the Act, on the ground that it puts a premium on risky banking methods and a penalty on sound and conservative banks. It was hoped that this would prove a way of unifying the banking system, as the final scheme is supposed to be limited to members of the Federal Reserve System. How this will work out ultimately remains to be seen. At present non-member banks are admitted to the benefits of the F.D.I.C.[2] Moreover, under the Robinson–Steagall Act of March 24th, 1933, they were granted for a year rediscounting facilities with the Federal Reserve Banks on the same terms as member banks. Whilst actually making use of these privileges they were to keep the same percentage reserve balances, and otherwise fulfil the obligations of member banks except for stock subscription.[3] Thus

[1] Harris, "Twenty Years of Federal Reserve Policy," Vol. II, pp. 837, 843, 849. Cf. *Federal Reserve Bank of New York Monthly Review*, February 1934, pp. 9–10, for a chart showing that member banks in the New York Federal Reserve District lost reserve balances amounting to $1·5 thousand millions through Treasury transactions in the years 1932–33 and the movement "continued at an accelerated rate in January 1934."

[2] 19 *Federal Reserve Bulletin* (July 1933), p. 388, and (October 1933), p. 597.

[3] 19 *Federal Reserve Bulletin* (April 1933), p. 247. See also M. Nadler and J. I. Bogen, "The Banking Crisis," New York, 1933, p. 180. This Act has not been extended.

no real progress has been made till now towards a genuine unification of the banking system. Nor has there been any adequate provision for branch banking, as Section 23 of the Banking Act of June 16th, 1933, was whittled down to a mere permission for each National Bank to open branches within the same State to the extent expressly permitted to State banks by the laws of the State.[1]

An illustration of the tendency towards more Government control in the Federal Reserve System is seen in the drastic powers which the Banking Act of 1933 gives to the Federal Reserve Board to take "direct action" against member banks and their officers with a view to preventing undue speculation and stock-market booms such as that of 1929. It is also very noteworthy that the inflation amendment to the Farm Relief Act of May 12th, 1933, incidentally gives two potentially very important new powers to the Federal Reserve Board, and that they cannot be exercised without specific approval from the Administration on each occasion. The Board is empowered, with the approval of the Secretary of the Treasury, to require the Federal Reserve Banks to take action to prevent undue credit expansion. It may also, by the affirmative vote of at least five members and with the approval of the President of the United States, declare that an emergency exists by reason of credit expansion, and proceed to alter from time to time during the emergency the percentage of reserves required to be held by member banks against demand or time deposits.[2]

It may be conjectured that the Federal Reserve authorities were not very enthusiastic about the President's gold-purchase plan, put into force from October 1933, for gradual devaluation of the dollar by artificially depreciating the foreign exchanges. This created great uncertainty and flight of capital. In effect it favoured rich financiers and others who could get funds out of the country by various devices in spite of exchange restrictions, whilst owners of smaller amounts had to take

[1] 19 *Federal Reserve Bulletin* (July 1933), p. 398.
[2] W. O. Weyforth, "The Federal Reserve Board," pp. 150–3.

the full loss on them. There can be little doubt that, when the policy of devaluation had been adopted, it would have been better to devalue quickly by a single step or as few steps as possible. However, the Federal Reserve Board and Banks co-operated fully in carrying out the Government's policies. The only point on which it is known that there was definite opposition is in regard to the requisitioning of the gold belonging to the Federal Reserve Banks. It was agreed that the " profit " by the devaluation of the dollar should be credited to the Treasury, but the transfer of actual ownership of all gold to the Treasury was considered unnecessary. The Governor of the Federal Reserve Board says: " We felt the gold should remain with the central banks of the Nation for manifest purposes of currency and credit needs." [1]

By the Gold Reserve Act of January 30th, 1934, title to all monetary gold in the United States was vested in the Government. The Federal Reserve Banks were to hold their reserves in gold certificates redeemable only to the extent deemed necessary by the Secretary of the Treasury " to maintain the equal purchasing power of every kind of currency of the United States." [2] The Treasury announced on January 31st, 1934, that it would buy gold at $35 per troy ounce of fine gold, less one-quarter per cent. and mint charges, and that it would sell at $35 per ounce plus one-quarter per cent. for export to foreign central banks when exchange rates with gold standard currencies should reach gold export point. Purchases and sales are made through the Reserve Bank of New York as fiscal agent, and the prices are subject to change without notice.[3] By Section 10 of the Gold Reserve Act a Stabilisation Fund of $2 thousand millions from the " profits " of devaluation was established to enable the Secretary of the Treasury to deal in gold and foreign exchange for the purpose of

[1] 20 *Federal Reserve Bulletin* (February 1934), p. 75.

[2] Section 6 of the Act. 20 *Federal Reserve Bulletin* (February 1934), p. 65.

[3] *Ibid.*, pp. 68–9.

stabilising the exchange value of the dollar. Any part of the fund not currently required for this purpose might be invested in Government securities. It is not known to what extent, if any, this Fund has actually been used.[1]

On February 10th, 1934, the President sent a letter to the Governor of the Federal Reserve Board expressing "appreciation of the splendid services that the Federal Reserve System has rendered," and stating that the Gold Reserve Act in no way impairs the strength, powers or responsibilities of the Reserve Banks.[2] Nevertheless, it is clear that the Act goes a long way towards putting the Treasury back in the position of a Central Bank, and the prestige and powers of the Federal Reserve authorities must necessarily suffer. One writer says:

> "The transfer of central banking powers under the Act of January 30th, 1934, to the Treasury, has paved the way for the further weakening of the Federal Reserve system, already badly weakened by earlier events." [3]

It is now an every-day occurrence to read in newspapers and periodicals paragraphs like the following:

> "The policy of the Treasury up to this time has been to 'sterilise' the gold profit, and raise sufficient money by borrowing to handle all current expenses. This has been pursued to avoid, as far as possible, the danger of undue credit inflation." [4]
>
> "Government deposits in subscribing banks . . . remained unchanged in the New York district. This makes it fairly obvious that the cashing of Treasury [gold] certificates at the Federal Reserve went on at a greater rate than before." [5]

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[1] The Treasury Daily Statement shows that on April 27th, 1934, $200 millions was deposited by the Treasury with the Reserve Banks for the Stabilisation Fund by selling them gold certificates for that amount. This suggests that the Fund is beginning operations or will soon do so. See *New York Herald Tribune*, May 1st, 1934, p. 25. It has since been announced that the Stabilisation Fund's deposits with the Reserve Banks are now included under "Other Deposits," and not under "Government Deposits."

[2] 20 *Federal Reserve Bulletin* (February 1934), p. 61.

[3] Mr. L. Shere in "The Banking Outlook," by H. P. Willis and others, p. 912.

[4] *New York Times*, March 2nd, 1934.

[5] *New York Herald Tribune*, March 20th, 1934.

"The Treasury, by holding back from deposit with the Federal Reserve certificates for some of the imported gold, is not 'reversing the easy money policy.' . . . The Treasury has turned from depositing certificates for free gold with the system to filling its needs for cash by calling on depositaries. This . . . represents only a return to normality." [1]

"Quite obviously, the Treasury, which now exercises full control of the credit reservoir, is diligently pumping new supplies into the market, regardless of the complete lack of any new requirements." [2]

"Treasury policy again was the most important factor in causing the further expansion . . . of member bank reserves [to about $1·7 thousand millions]. The Treasury's deposit with the Federal Reserve fell $51,000,000, and the Treasury seems, in addition, to have made use of around $5,000,000 more of its free gold." [3]

The "profit" from devaluing the dollar was about $2·8 thousand millions, of which $2 thousand millions went to the Stabilisation Fund. The Treasury then held about $800 millions of "free gold" not pledged against gold certificates or other specific liabilities. By issuing gold certificates against part of this gold to the Reserve Banks in return for deposits, the Treasury increases the reserves of the Reserve Banks. By spending the resulting deposits it increases member banks' reserves to the same extent. Conversely, the Treasury could demand gold certificates for its deposits and increase its free gold. The "release of free gold" by the Treasury increases both member banks' reserves and the Reserve Banks' reserves by the amount released, just like an import of gold under the old system. The spending of any part of the Stabilisation Fund operates in exactly the same way. All imported gold is now sold to the Treasury, which pays for it from its deposits in the Reserve Banks. This increases member bank reserves, but they are equally reduced by the extra transfers from special depositaries to balance the payment. The net result is only an increase of the Treasury's free gold, and the

[1] *New York Herald Tribune*, March 23rd, 1934.

[2] *Commercial and Financial Chronicle*, April 14th, 1934, p. 2461.

[3] *New York Herald Tribune*, April 27th, 1934.

TABLE III

NUMBER OF UNITED STATES GOVERNMENT DEPOSITARIES [1] IN EACH CLASS AT THE END OF THE FISCAL YEAR, 1913–33.

June 30th.	Sub-treasuries.	Federal Reserve Banks and branches.	Federal Land Banks.	Temporary National Bank Depositaries.[2]	Depositary Banks.				Insular (including Philippine Treasury).
					General.	Limited.	Special.[3]	Foreign.	
1913	9			691	850				2
1914	9			622	961				2
1915	9			624	849				2
1916	9	12		607	774				2
1917	9	13		591	764		1639		2
1918	9	15		580	781		6510	11	2
1919	9	30	1	566	765		9550	22	2
1920	9	33	12		587	116	9475	17	6
1921		35	12		533	187	9412	16	5
1922		35	12		335	845	8439	12	5
1923		35	12		312	881	8110	11	5
1924		35	12		304	885	7815	10	6
1925		35	12		299	873	7645	10	6
1926		35			316	972	7478	7	7
1927		35			321	960	7224	8	7
1928		37			318	966	2964	9	7
1929		37			322	972	2249	11	5
1930		37			316	1035	2094	12	3
1931		37			314	1031	2079	11	3
1932 [4]		37			311	984	3208	11	3
1933 [4]		37			317	980	3127	13	3

Source.—Annual Finance Reports of the Secretary of the Treasury.

[1] The Treasurer of the United States was also a depositary throughout. The Finance Reports before 1932 usually contain two sets of figures for depositaries. One is in the section relating to the "Division of Deposits," and the other in the Treasurer's Report. They practically never agree. The figures given by the Division of Deposits have been followed here, so far as available. The differences for general depositaries are not large. For limited depositaries the differences are chiefly due to the Treasurer's counting branches of the same bank separately in the total. For special depositaries the Treasurer sometimes gives the number actually holding balances, whilst the Division of Deposits gives the number of banks qualified (see Finance Report, 1930, pp. 130, 650). But in 1931 the Division of Deposits gives the total number as 2,079, of which 1,269 held deposits, whilst the Treasurer's figure is 1,408 (Finance Report, 1931, pp. 135, 495). Probably the Treasurer counted branches again.

[2] In the table given by Professor Chapman (*op. cit.*, p. 117) the temporary depositaries up to 1916 are placed in the column for special depositaries, along with the new and quite different special depositaries which only came into existence in 1917 on account of the War. The temporary National Bank depositaries with inactive accounts existed long before the War, and it is unfortunate that they were also sometimes known as special depositaries.

[3] The general and limited depositaries were all National Banks until 1928, when all member banks of the Federal Reserve System became eligible. The special depositaries instituted in 1917 always included any banks that cared to qualify whether or not they were members of the Federal Reserve System.

[4] Finance Reports, 1932, p. 122, and 1933, p. 69. The figures for general and limited depositaries are not given separately in these Finance Reports, which show only a total of 1,295 banks (and 160 branches) for June 30th, 1932, and a total of 1,297 banks (and 184 branches) for June 30th, 1933, under "member bank depositaries," including both general and limited depositaries. The separate figures for banks designated as general depositaries and as limited depositaries respectively were kindly furnished by the Secretary of the Treasury. The composition of these totals as between National Banks and State Banks and trust companies is not available. The 3,208 special depositaries existing on June 30th, 1932, included 1,918 National Banks and 1,290 State banks and trust companies. Only 1,397 of the whole number were actually holding Government deposits at that date.

Treasury releases this gold at its discretion as already described. Besides having the power to vary the reserves of both Reserve Banks and member banks in this way, the Treasury is practically able to direct the open-market operations of the Reserve Banks, and through the Stabilisation Fund it is also responsible for the exchange value of the dollar.

That the U.S. Treasury is now acting as a Central Bank does not appear to be open to question, though the accounts between the Treasury and the Federal Reserve Banks are so complicated that it is often not possible to make out the exact nature and effects of the Treasury's operations. The Reserve Banks at present seem to function practically as Government banks and instruments of Treasury policy. How long this arrangement will last, and how successful it will be, time alone can show. The history of the Independent Treasury does not augur well for the experiment. The whole experience of the United States seems to show the great desirability of keeping banking and monetary policy as far removed from party politics as possible in normal times. Probably the majority of well-informed Americans hope that the assumption of direct central-banking functions by the Government, which was perhaps inevitable in the emergency, will not be continued after the crisis has been surmounted. But will well-informed opinion prevail?

CHAPTER VI

CONCLUSION

THE two countries which we have been studying are of very special importance in the realm of finance and banking. They are in a position to provide effective leadership for the world in rebuilding a stable international monetary standard, if they can agree on a definite policy and co-operate fully in carrying it through. Their prestige has been so great that some parts of their central banking systems have been widely imitated by other countries.

The arrangements in regard to Public Deposits and the National Debt, that arose in England by a long process of evolution, have been adopted more or less as a whole in some other countries. Perhaps the first of these was the United States. It has been said that

> "the charters of the First and Second Banks of the United States were modelled upon that of the Bank of England, and if they had lasted it is probable that they would have followed a similar course of evolution." [1]

Certainly the centralisation of Government transactions in these Banks was quite comparable with the arrangements in England. The English system of concentrating Public Deposits in the Central Bank was adopted by Belgium in 1872, and later by Holland and Italy.[2] It is also coming into effect in all the British Dominions, as they develop their own Central Banks. The Financial Committee of the League of Nations attached great importance to this point when helping to reorganise a number of European Central Banks in the post-war

[1] Myers, p. 425. [2] Philippovich, pp. 263, 268.

decade, namely, those of Austria, Hungary, Bulgaria, Esthonia and Greece.[1] The English system has also been very completely put into effect in the U.S.S.R. from 1928, judging by the account given in "Soviet Public Finance" by G. Y. Sokolnikov and Associates, pp. 450–3. Public Deposits are not always free of interest, as in England. In Belgium they were invested as a rule in foreign bills, at any rate till the 1931 crisis, and the net proceeds are payable to the Government. In Bulgaria, Esthonia and Greece the Central Banks may pay interest to the Government on that part of the Public Deposits which is held in foreign bills, but the rate must be at least one per cent. less than the average rate earned on these funds.[2]

The great advantages of concentration of Government transactions in the Central Bank are administrative simplicity, economy and safety of balances, a ready means of ascertaining the state of the national accounts, and finally a strengthening of the Central Bank's control over the money market. It is not likely that there is any Central Bank which does not perform some banking services for its Government. But the Central Bank may only have custody of the Government's surplus funds, and be responsible when requested for transfers from one part of the country to another, whilst actual payments and receipts still take place mainly at the central and provincial treasuries. This is roughly the present position in France; the Central Bank, it has been said, acts as banker, but not as cashier, to the Government, and this system does not secure the above-mentioned advantages.[3] The position in Germany was somewhat similar, at any rate till recently.[4] Moreover, certain funds of public and semi-public bodies in Germany were not kept in the Reichsbank, but used elsewhere for the sake of earning interest in a way that proved embarrassing to the Central

[1] E. Ulrich, "Les Principes de la Réorganisation des Banques centrales en Europe après la Guerre," Paris, 1931, p. 287.

[2] *Ibid.*, pp. 290, 297–8.

[3] *Ibid.*, pp. 286, 289–91, 295.

[4] Philippovich, p. 262.

Bank in its control of the money market.[1] The policy of President Schacht during his periods of office at the Reichsbank has always been to work towards having all Public Deposits centralised there. The recent trend towards centralisation of governmental functions in Germany may prove to be favourable to the concentration of Government deposits and transactions in the Central Bank.

Similarly in regard to the management of the National Debt two policies are possible. The Bank of France only performs certain specified and very limited functions for the French Treasury.[2] Recently it has become much more common to follow the British model, and transfer the whole management of the Debt, lock, stock and barrel, to the Central Bank. It seems logical to do this where the policy of concentrating the Government's current transactions in the Central Bank has been adopted.[3]

In the Federal Reserve System the English practice is also followed to a large extent in that the great bulk of the Government's financial business is centralised at the Reserve Banks. The very interesting use of the commercial banks as special depositaries is, however, a novel feature. It does not seem to have spread to any other countries yet, but may perhaps do so, if it is successfully adjusted to normal conditions and becomes better known. The Federal Reserve System has, of course, influenced Central Bank constitutions very considerably in other American countries. The fixed percentage reserves against notes and deposits have been imitated much more widely. This makes it seem strange that the depositary system of the United States has been so little understood outside the country.

Our detailed study of the arrangements in England and the United States fully bears out, and in fact strengthens, the tentative conclusions arrived at in the

[1] Ulrich, p. 294. M. Helwig, " Die öffentlichen Gelder am deutschen Geldmarkt," Hamburg, 1930, pp. 74–87.

[2] H. E. Fisk, " French Public Finance," New York, 1922, pp. 264–5.

[3] Ulrich, pp. 315–16.

introductory chapter as to the relative merits of keeping Government deposits in the Central Bank or in the commercial banks. In general, there is a strong presumption that it will be most satisfactory to entrust them to the Central Bank. It is possible under some circumstances, however, to make some use with advantage of the commercial banks along with the Central Bank, as is done in the United States. The special depositary system of the United States has perhaps not yet evolved to the highest possible degree of perfection, and it should be possible to improve it considerably. But it has certainly proved to be very useful in the United States, and it deserves more consideration by other countries than it has yet received.

The Bank of England and the Federal Reserve System have been referred to by one writer as the " Anglo-Saxon strongholds of central bank independence."[1] Our study of the Federal Reserve System, however, indicates that Government control has always been fairly strong there. The Financial Committee of the League of Nations did its best after the War to foster the legal independence of Central Banks. But even in a League of Nations publication the statement can be found that

> " the legal status of the Central Banks as formally independent private banks under Government control or as pure State banks has had but little effect upon their actual credit relations with the Governments." [2]

This statement referred to the War and early post-war years. It is equally true that in the pressing emergency of 1930–34 Central Banks have everywhere become instruments of Government policies, whatever their legal status may be.

Public opinion at the moment is on the whole unfavourable to Central Bank independence. The assumption of control by political authority, which we have seen taking place in England and the United States, was undoubtedly

[1] L. D. Edie, " Dollars," p. 196.

[2] " Memorandum on Central Banks," Geneva, 1924, p. 57.

supported by the great majority of the public. The general shift of opinion is illustrated by the determined efforts to introduce clear Government control into the new Reserve Banks proposed for Canada and New Zealand. Another indication is the conversion of the Danish National Bank from a joint-stock bank with private stockholders into an institution owned and controlled by the Government which is to take place as from May 1st, 1934.[1]

Economists and bankers on the whole are much less enthusiastic about this establishment of political control over the banking and credit system than are the general public and the politicians. They see very clearly the possibility of disaster from rash and hasty experiments by persons without expert knowledge in this field. But economists and bankers are rather at a discount just now. Most peoples and Governments seem determined to ignore their advice in regard to central banking, as in regard to tariff policy and many other matters of economic importance. Let us hope that this is a passing phase. We must distinguish clearly between ends and means. The whole community through its proper representatives must no doubt have the ultimate control and the last word as to central banking policies. But it should use its power only to choose certain general ends, and to provide for the best possible choice of experts to organise the means for attaining those ends. Just now the pendulum has swung too far in the direction of interference by political authorities in the details of central banking. The community must give its central banking experts a fair degree of freedom and real responsibility, or they will have but a poor chance of attaining the ends prescribed. As already suggested, it seems likely that the final control over economic experts would be exercised best by an authority representing the whole community organised on economic rather than political lines.

Mr. Lionel Edie foresees a long period in which money questions will be leading issues both in domestic politics

[1] *New York Herald Tribune*, April 18th, 1934.

and also in international relations and negotiations between Governments. He thinks that Treasuries will continue to dominate Central Banks, and that rates of exchange will be used as weapons in a new economic warfare.[1] This certainly is not a promising road towards better times for the world. Is it not possible that the leading peoples will soon tire of such profitless disputes, and insist that their Governments agree on a new international standard and leave the Central Banks free to co-operate in keeping it stable and working it smoothly?

Governments have not shown much capacity for co-operation in the economic realm, but there is a fair prospect that Central Banks would co-operate with increasing effectiveness, if they were really given the chance. The Bank of England took the lead in trying to bring about Central Bank co-operation after the War, and achieved a good deal of success in a quiet way. The movement culminated in the establishment of the Bank for International Settlements in 1930. It has sometimes been suggested that the Bank of England was to blame for not summoning a conference of Central Banks, as proposed by the Genoa Conference of 1922. Mr. Montagu Norman has made it clear that the real obstacles were political:

> "It always appeared impossible (he says) during those years when we were waiting, to summon such a conference, for the excellent reason that the people would not come. They would not come, not because they were unwilling to co-operate, but because they were unwilling to face the publicity and the questionings in their own countries which would arise if they attended any such conference, and all the attempts that I made to that end failed." [2]

Evidently if Governments and peoples were really anxious for Central Banks to co-operate they would not hesitate to do so, and there would not be this great dislike of publicity on the part of some Central Banks.

The most striking example of a definite refusal by a

[1] L. D. Edie, "Dollars," 1934, pp. 19–20.

[2] Evidence before the Macmillan Committee (Qn. 9188).

Government to allow its Central Banking System to follow its own wishes in arranging for co-operation with other Central Banks is found in the United States. When the Bank for International Settlements was under consideration, the State Department issued a communiqué on May 16th, 1929, stating that the United States would not recognise the Bank, and would not allow the Federal Reserve Banks to subscribe to its stock, or permit a representative of the Federal Reserve System to sit on its Board of Directors. An American writer maintains that this action was "extra-legal" and "unnecessary."[1] The hope has often been expressed in America and elsewhere that the matter may be reconsidered.

Our survey of the relations between Treasuries and Central Banks can only end on a note of interrogation. The present position is very clear, but the future is most uncertain. It depends very greatly on what is done by the two leading financial countries. There is no doubt that other Governments and Central Banks would be strongly inclined to follow any wise lead from these quarters. The world looks to the United States and the United Kingdom to show the way towards right solutions of the great problems of "Central Bank independence" and "co-operation of Central Banks."

[1] Eleanor L. Dulles, "The Bank for International Settlements at Work," pp. 50, 83–6, 505.

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